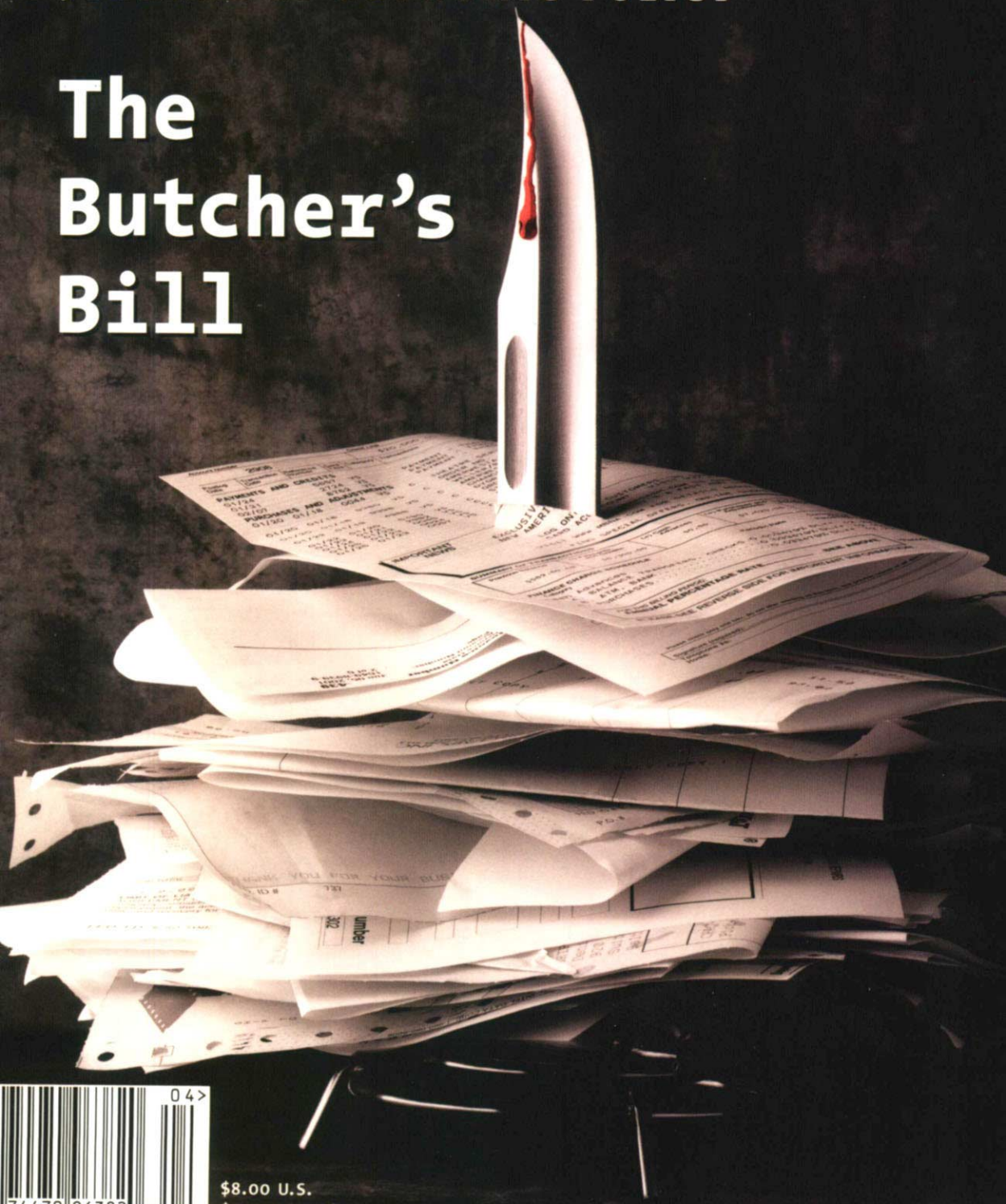
THE MILKEN INSTITUTE
# Review
FOURTH QUARTER 2001
A JOURNAL OF ECONOMIC POLICY

# The Butcher's Bill



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THE MILKEN INSTITUTE REVIEW • FOURTH QUARTER 2001

VOLUME 3, NUMBER 4

THE MILKEN INSTITUTE

Michael R. Milken, *Chairman*

PUBLISHER

Joel Kurtzman

EDITOR IN CHIEF

Peter Passell

ART DIRECTOR

Joannah Ralston, Insight Design

MANAGING EDITOR

Larry Yu

ISSN 1523-4282
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The Milken Institute
Santa Monica, California

*The Milken Institute Review is published quarterly by the Milken Institute to encourage discussion of current issues of economic policy relating to economic growth, job creation and capital formation. Topics and authors are selected to represent a diversity of views. The opinions expressed are solely those of the authors and do not necessarily represent the views of the Institute.*

Requests for additional copies should be sent directly to:

The Milken Institute
The Milken Institute Review
1250 Fourth Street, Second Floor
Santa Monica, CA 90401-1353
310-998-2600 telephone
310-998-2627 fax
info@milkeninstitute.org
www.milkeninstitute.org

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**Could individual** retirement accounts bridge the ideological gap that is frustrating efforts to reform Social Security? Can a politician who despises politics save the Japanese economy from a depression? And while we're at it, what's a fair price to pay for a Mercedes-Benz 300SL Gullwing from the 1960s?

The answers and much more await you in this, the 12th issue of the Milken Institute's journal of economic policy.

First things first: Topic A in the *Review* and everywhere else remains the tragedy of September 11. Economists bring no special insights into the meaning of acts of terrorism. But they can tally the tangible damages, and perhaps offer a way to think about the far greater intangible losses. Here, **Peter Navarro** of the University of California (Irvine) Graduate School of Management takes on the task.

Navarro totes up the butcher's bill – a figure that easily exceeds $100 billion when the value of the lives lost is included, in the only way economists know to make the calculation. But the more important contribution of his reckoning is the insight that the ultimate cost will turn on choices yet to be made: "On one level, policymakers risk investing too little in minimizing the intangible (but very costly) inconveniences associated with the need for increased security," he writes. "On quite another level, they must deal with the potential for increased volatility in the business cycle that could permanently reduce the economy's growth potential."

**Tim Taylor**, managing editor of the American Economic Association's *Journal of Economic Perspectives*, wades into the fray over the privatization of Social Security – in particular, the creation of individual retirement accounts as a supplement to the public pension system. He favors individual accounts – but not for the reason they have become the darling of Dubya's policy advisers.

Indeed, Taylor has an entirely different agenda. "The establishment of individual accounts – a primary goal of conservatives," he writes, "could be used as the political quid pro quo for raising Social Security taxes, which is likely to be a necessity to address long-term solvency, since the political will for cutting Social Security benefits hovers just above absolute zero."

**Victoria Marklew**, senior international economist at Northern Trust, takes a hard look Prime Minister Junichiro Koizumi's chances for pulling Japan out of its long slump. She's torn between the hope that Japan's first un-politician can change the politics of reform, and the knowledge that the economy's problems are far graver than generally realized.

With "a financial system stunted by decades of pork-barrel economics, Koizumi's reforms imply a fundamental reorientation of the way that Japan's entire political-economic



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system has functioned since the post-World War II occupation," she writes. "Attempting this undertaking at a time when the banks' financial health is compromised and the global economy is sputtering is risky, indeed."

**Robert Walker** of the University of Nottingham and **Michael Wiseman** of George Washington University explain Britain's ambitious – and impressive – efforts to reform the country's public assistance system without damaging the social safety net.

"While the British vision of welfare for the 21st century is surely far from complete," they write, "change is ongoing, and new institutions are under construction. From the beginning, New Labour's vision has been captured by an extremely effective mantra – 'work for those who can, security for those who cannot.' The U.S. equivalent, 'end welfare as we know it,' is no longer pertinent."

**David Evans** of National Economic Research Associates examines the startling success of "free" software – ambitious undertakings such as the Linux operating system, which was apparently built without benefit of the profit motive. While respectful of the accomplishments of what is generically called "open source" development, Evans doubts the movement offers a viable alternative to the gospel according to Adam Smith.

"As it evolves from a hacker phenomenon to an industry backbone with formal institutions," he writes, "it is easy to imagine that those who offer assistance because they like being part of a cool club will find it less alluring – sort of like the difference between hanging out at a funky café and one of the six Starbucks on your block."

Even in these sad, perilous times my readers deserve diversion – albeit one with redeeming economic significance. And **Rick Carey**, a frequent contributor to *AutoWeek*, *Classic & Sports Car* and *Ferrari Market Letter*, has just the ticket: an analysis of the auction market for collector cars. Ready to spend $3 million for an Alfa 8C 2300 Touring-bodied Spider? No matter; Carey offers other options.

"Collecting cars doesn't stack up well as an investment, even buying when the market is weak," Carey writes. "As an avocation, however, there may be few other ways to have so much fun, meet so many good people, visit such neat places as honored guests, and participate in the preservation of an important part of modern history at such reasonable cost and acceptable risk."

AP/WIDE WPRLD PHOTOS

Wait; there's more. I've managed to obtain rights to reprint a delicious excerpt from **Barbara Ehrenreich**'s bestseller, *Nickel and Dimed*. **Ross DeVol**, the Milken Institute's regional development guru, counters the currently fashionable pessimism infecting the long-term outlook on technology and growth. **Bill Frey**, our demographer-in-residence, culls some fresh insights from the 2000 Census about the return of blacks to the American South. **Steve Postrel** comes through with a new puzzler. And **Mark Alan Stamaty**, whose *Ekinomix* cartoon usually satirizes the doings of the rich and powerful, makes no attempt whatsoever to be funny about the World Trade Center massacre.

— *Peter Passell*



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BY WILLIAM H. FREY

# Coming full circle, blacks in America ended the 20th Century by returning to the region that they spent most of the century leaving. As such, the South retains its historically distinct racial profile as a region of whites and blacks, bucking the broader trend in the rest of America, where Latinos and Asians are a rapidly growing presence.

The 2000 Census shows that the South increased its attractiveness to blacks in the booming economy of the 1990s. Dixie's black population rose by 3.6 million – more than the other three regions combined. That figure represents about twice the number of blacks the South gained in the 1980s, and is well above the gain for the 1970s – the first decade in which blacks began returning to the South. Still, the 1990s are distinct because of the sheer magnitude of black Southern gains, and because it is the first decade in which each of the other major regions registered a net out-migration of blacks.

## SOUTHERN STATES AND METRO AREAS DOMINATE

As recently as 1965-70, the South was losing migrants to the Northeast, Midwest and West, where the greatest black-gaining states were New York, California, Illinois, Michigan and New Jersey. Blacks now locate to many of the same metropolitan areas that attracted whites to the "New Sunbelt." Among the 32 metro areas that are home to more than 200,000 blacks, Southern metros, led by Orlando and Atlanta, dominate the list. Like whites, blacks are attracted to the good economy, low-density living and warmer climate. In addition, they hold historic roots to the South, and recognize that the climate in race relations has much improved.

## BLACK MOVEMENT IS SELECTIVE

Although the South is attracting blacks on all rungs of the social ladder, about 19 percent of black in-migrants to the South are college graduates, compared with 13 percent of all black Southern residents. Among those who work, nearly three out of ten black in-migrants to the South are professionals and managers. The region's special attraction for them is the presence of a large black middle class in large metropolitan areas including Atlanta, Charlotte and Dallas, which creates opportunities for networking and upward mobility.

Most are heading for the suburbs. Four Southern blacks in ten now live in suburbs. Among the new in-migrants, however, 70 percent have chosen suburban residences. And many more are ending up in integrated neighborhoods, with Atlanta, Orlando, Jacksonville,

BILL FREY is a senior fellow in demography at the Milken Institute.



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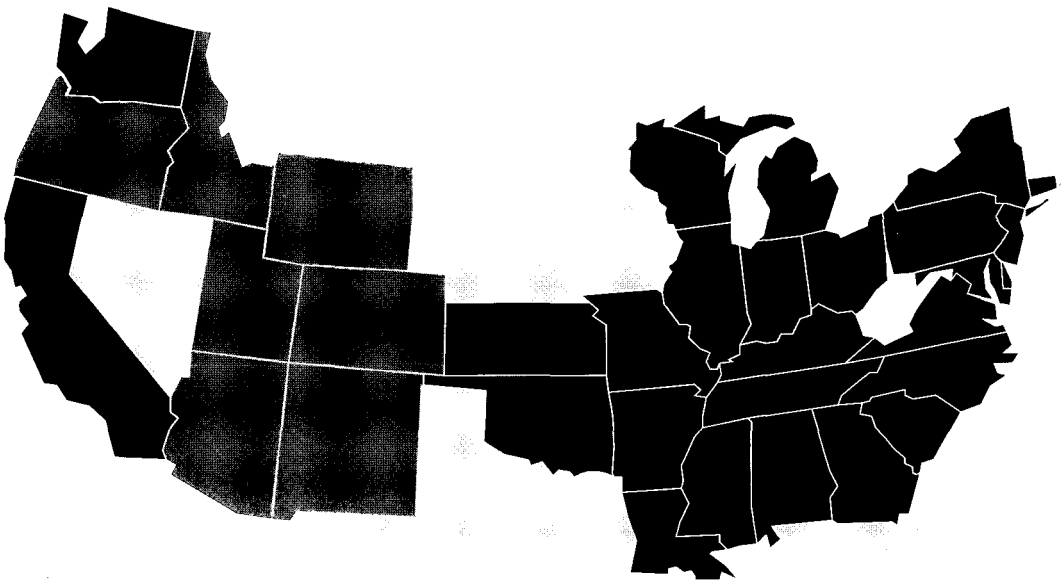
## BLACKS OUTNUMBER HISPANICS IN THE SOUTH

**RELATIVE SIZES OF BLACK AND HISPANIC POPULATIONS IN STATES**



Neither group comprises 5% of population
Hispanics outnumber blacks by less than 4 to 1
Hispanics outnumber blacks by at least 4 to 1
Blacks outnumber Hispanics by less than 4 to 1
Blacks outnumber Hispanics by at least 4 to 1

**SOURCE (ALL):** William H. Frey, analysis of Census data.

BRUCE SANDERS (ALL)

Norfolk and Houston leading the trend.

### BLACKS AND HISPANICS IN THE SOUTH

Much has been made about the fact that, nationally, the Hispanic population now rivals that of blacks. Yet recent redistribution shifts tend to reinforce the South's historic racial profile as a primarily white-black region. The lion's share (71 percent) of the region's Hispanic population gains accrued to Texas and Florida. The rest of the South gained 2.4 million blacks during the 1990s, compared to just 1.4 million Hispanics. Even including Texas and Florida, the South's 2000 black population comprises 19 percent of its total, and whites 66 percent, whereas Hispanics account for only 12 percent. In short, the South continues to remain a largely white-black region.



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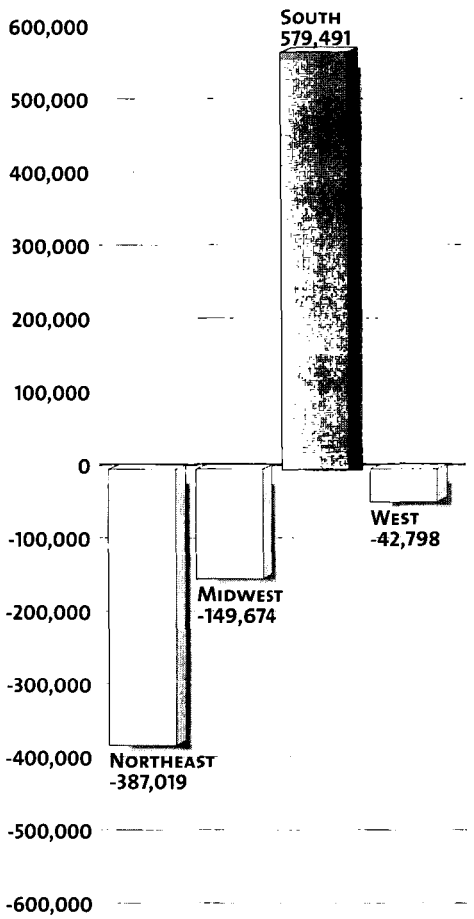
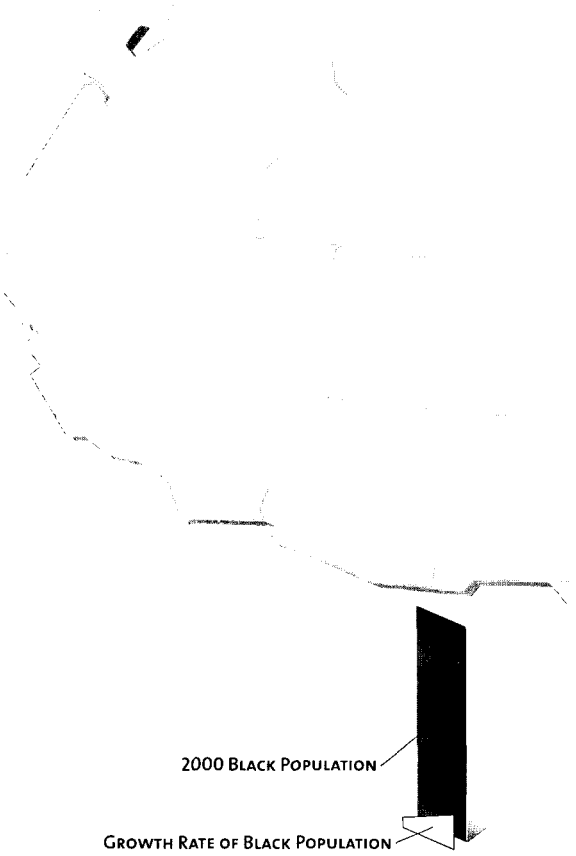
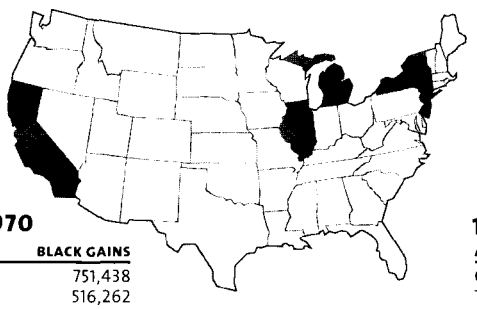
## BLACKS RETURN TO THE SOUTH

### CHANGE IN BLACK POPULATION 1990-2000



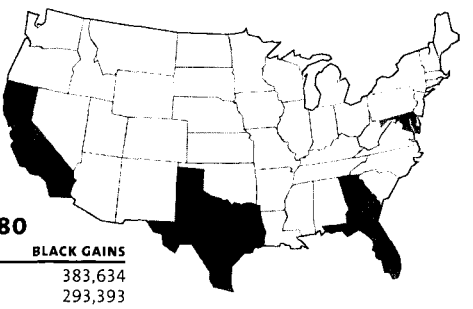




## STATES WITH LARGEST BLACK POPULATION GAINS



**1960-1970**

| AREA | BLACK GAINS |
|---|---|
| New York | 751,438 |
| California | 516,262 |
| Illinois | 388,204 |
| Michigan | 273,485 |
| New Jersey | 255,417 |



**1970-1980**

| AREA | BLACK GAINS |
|---|---|
| California | 383,634 |
| Texas | 293,393 |
| Florida | 275,748 |
| Georgia | 260,976 |
| Maryland | 250,985 |



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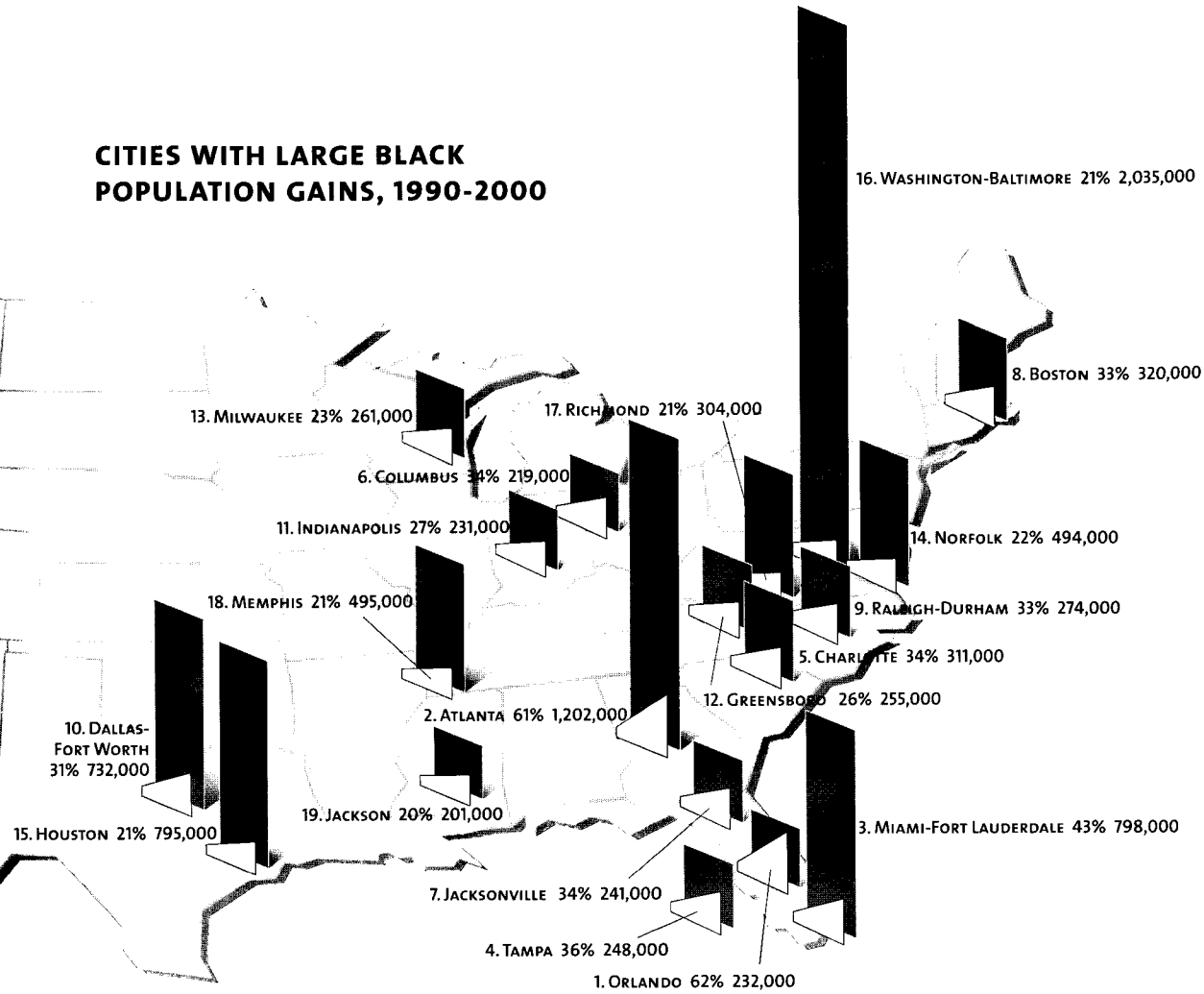
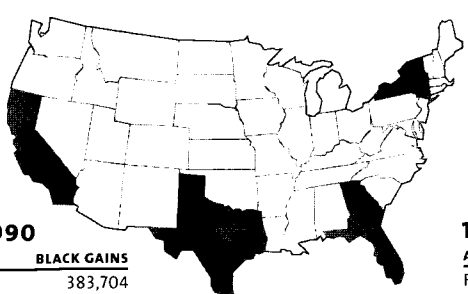
## CITIES WITH LARGE BLACK POPULATION GAINS, 1990-2000

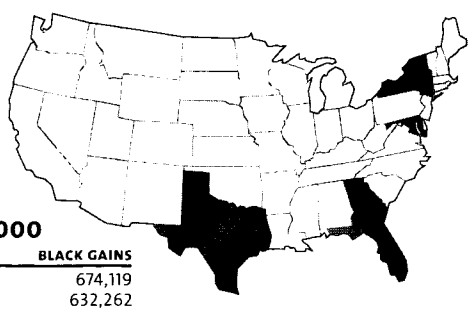

16. WASHINGTON-BALTIMORE 21% 2,035,000
8. BOSTON 33% 320,000
13. MILWAUKEE 23% 261,000
17. RICHMOND 21% 304,000
6. COLUMBUS 34% 219,000
11. INDIANAPOLIS 27% 231,000
14. NORFOLK 22% 494,000
18. MEMPHIS 21% 495,000
9. RALEIGH-DURHAM 33% 274,000
5. CHARLOTTE 34% 311,000
12. GREENSBORO 26% 255,000
2. ATLANTA 61% 1,202,000
10. DALLAS-FORT WORTH 31% 732,000
19. JACKSON 20% 201,000
15. HOUSTON 21% 795,000
3. MIAMI-FORT LAUDERDALE 43% 798,000
7. JACKSONVILLE 34% 241,000
4. TAMPA 36% 248,000
1. ORLANDO 62% 232,000

**NOTE:** Cities ranked by growth rate of black population.



### 1980-1990

| AREA | BLACK GAINS |
|---|---|
| Florida | 383,704 |
| California | 308,669 |
| Georgia | 289,040 |
| Texas | 283,962 |
| New York | 269,999 |



### 1990-2000

| AREA | BLACK GAINS |
|---|---|
| Florida | 674,119 |
| Georgia | 632,262 |
| Texas | 453,606 |
| New York | 393,736 |
| Maryland | 329,105 |



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BY TIMOTHY TAYLOR

# There's really no reason for surprise – or anger – that the President's Commission to Strengthen Social Security has signaled its intention to recommend some form of individual accounts to supplement Social Security. After all, President Bush's executive order establishing the commission in May 2001 set forth six guiding principles, and No. 6 is: "modernization must include individually controlled, voluntary, personal retirement accounts, which will augment the Social Security safety net." Complaining because presidential appointees are obeying marching orders is like attending a performance of *King Lear* and wondering why it wasn't *The King and I*. Maybe the show isn't what you wanted, but the marquee over the front door should have given you a strong hint about what you were going to see.

What is reasonable to ask, though, is how well a president's commission that was formed to advocate individual accounts makes the case. So far, it has published only an interim report. The final version, originally scheduled for December, may slip into 2002. But for friends of individual accounts like me, it's not too early to start worrying that the commission's work will confuse and politicize the case for individual accounts, while failing to address the issues that have allowed Social Security's long-term solvency problems to fester for a decade.

## THE EASY, POINTLESS QUESTION

When advocating a role for individual accounts, there is an easy, pointless question, and a difficult, revealing one. Here's the easy question: Is it possible to construct a proposal for making Social Security solvent in the long term that uses individual accounts? The easy answer is "of course." But no amount of repetition of this little catechism demonstrates that individual accounts are either necessary or sufficient for such a solution. There are straightforward methods for making Social Security solvent that don't have even a hint of individual accounts.

Nonetheless, supporters of individual accounts almost always begin with an invocation of the long-term financial imbalances faced by Social Security. Although Social Security is presently accumulating a trust fund, they explain, the balance will start to be drawn down in 2016. And by 2038 the cupboard will be bare. Thereafter, payroll taxes

TIMOTHY TAYLOR is managing editor of the *Journal of Economic Perspectives*, based at Macalester College in St. Paul, Minn.



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will cover a little less than three-quarters of the benefits scheduled to be paid out. The president's commission calculates that the cumulative shortfall between currently scheduled taxes and currently promised benefits in the Social Security system will total $7 trillion by 2040, $14 trillion by 2050, and $47 trillion by 2075 (all in 2001 dollars).

There typically follows an extraordinarily vacuous argument over whether the Official Moment of Disaster for Social Security occurs in 2016 or in 2038. When the Titanic sunk, was the Official Moment of Disaster when the ship first nudged the iceberg or when the last smokestack disappeared beneath the waves? For the practical analysis of Social Security, all that matters is that the system as currently designed first bumps the iceberg in 2016. At that time, the rest of the budget will need to start making payments to the Social Security system to repay the government bonds held in the trust fund, which will change the equation that integrates Social Security politics and budget politics. The conflict with other budget resources will escalate until 2038, when the Social Security cupboard will be bare, and all payments to pensioners will have to come out of ongoing payroll taxes and general government revenues.

Arguments over whether the Official Moment of Disaster for Social Security hits in 2016 or 2038 tend to ignore the iceberg of insolvency. For anyone under the age of 60, the main point is that the amount of income we can expect from Social Security has a large component of political risk – a risk that increases each year the problem is not addressed.

Two years ago, the Social Security Administration published a memorandum listing a range of policy choices, together with what share of Social Security's funding gap over the next 75 years each would close. The table on page 11 lists some of these options, which, taken together, cover Social Security's unfunded deficit several times over.

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Individual accounts are only a mechanism. They can be used to adjust the obligations of the public pension system and its sources of revenue, but they offer no direct answer to the solvency problem. Individual accounts could even make Social Security's financial problems worse. For example, if people were allowed to divert a portion of their current Social Security payroll taxes to individual accounts, then it would be necessary to tap another source of funds to cover the outlays for current retirees.

Many of the other advantages commonly promised for individual accounts could be readily addressed in the present Social Security system as well. For example, advocates of individual accounts sometimes argue that people could gain higher returns by investing their personal accounts in stocks. Well, if the goal is higher returns through investing in stocks, the existing trust fund could be partly invested in stocks, too. Indeed, the Social Security Administration listed this option in the table.

Another appealing argument often made for individual accounts is that, unlike the present system, these accounts would allow individuals who die relatively soon after retirement to leave an inheritance. It is not obvious how large this benefit would be in practice. Many proposals for individual accounts require that individuals use much or all of their accumulation to purchase an annuity at retirement. The annuity would guarantee that people don't outlive their savings – but it would also mean that those who died earlier than expected would subsidize those who lived longer, just as presently occurs in the Social Security system.

Conversely, if a death benefit is desirable, then Social Security could be amended to pay one. Of course, an additional Social Security benefit would require either higher taxes or the diversion of funds that otherwise would have gone to monthly benefits for the living. But bequests from individual accounts don't offer a free lunch. Either more money would have to flow into these individual accounts to make the bequests possible, or the level of benefits for at least some recipients would need to be reduced to offset the bequests.

**When the Titanic sunk, was the Official Moment of Disaster when the ship first nudged the iceberg or when the last smokestack disappeared beneath the waves?**

You get the point; Social Security could, in theory, be amended to do just about anything individual accounts could do. Social Security could even be transformed into a giant investment fund in which everyone held individual accounts – although at this extreme the program would arguably stop being recognizable as Social Security.

### THE TOUGH, REVEALING QUESTION

Now for the tough question: What advantages of individual accounts are difficult or impossible to achieve through amendments to the existing system? The answer lies not in the technical capabilities of individual accounts, but in a political judgment. Individual ac-



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counts could help to loosen the political gridlock, so that America's public pension system can move to long-run solvency and full funding.

The establishment of individual accounts could be used as the political quid pro quo for raising Social Security taxes, which is likely to be a necessity to address long-term solvency, since the political will for cutting Social Security benefits hovers just above absolute zero. In his executive order creating the commission, President Bush stressed as his first guiding principle: "Modernization must not change Social Security benefits for retirees or near-retirees." Benefits might be trimmed back over time, especially if such cuts were smuggled into the political discussion under persuasive phrases like "raising the retirement age to account for longer life expectancies" or obscurant phrases like "changing average indexed monthly earnings to cover 40 years rather than 35 years." Even so, some significant increase in revenue is also likely to be needed.

How can the government assure current workers that an increase in Social Security payroll taxes would serve their interests, rather than being dissipated in the form of higher benefits for current retirees? Workers have a right to be skeptical. Many of us are paying Social Security taxes both to finance the retirement of this generation of retirees and to build up the trust fund that is supposed to help finance the next generation of retirees – all the while being told that the system will fall short when we retire ourselves. A policy that increases required contributions, but allows that money to be placed in individual accounts, offers some assurance to current workers that the extra revenues would actually go toward their own retirement.

Opponents of individual accounts often like to say that the present system requires only "relatively small adjustments in the program's parameters" (to quote an International Monetary Fund report). If you say it quickly enough, the payroll tax increase of 2.2 percent of wages that could solve all the system's problems (the amount shown in the table) doesn't sound like much.

**ADDRESSING SOCIAL SECURITY'S LONG-RANGE SOLVENCY PROBLEM**

| POLICY OPTION | PERCENTAGE OF LONG-TERM DEFICIT OVER 75-YEAR HORIZON RESOLVED |
|---|---|
| Reduce the Cost of Living Adjustment by 1 percentage point below the Consumer Price Index annually | 69% |
| Increase the number of years of earnings used to calculate benefits from 35 to 40 | 17% |
| Reduce benefits across the board by 5% | 30% |
| Raise the normal retirement age to 70 | 26% |
| Reduce benefits by 10% annually at family income of $40,000 and by an additional 10% for each additional $10,000 of income (maximum reduction of 85%) | 80% |
| Raise payroll tax rates (for employers and employees combined) by 2.2 percentage points | 104% |
| Make all earnings subject to the payroll tax | 98% |
| Require all newly hired state and local government employees to join Social Security | 11% |
| Invest 40% of the Trust Fund in stocks | 48% |

**SOURCE:** Social Security Administration, "Information on the Distributional Effects of Various Social Security Solvency Options by Gender and Income," May 18, 1999.

But slow down. For a family making $50,000 per year, a 2.2 percentage point increase represents an extra $1,100 per year in payroll taxes. Maybe four-figure tax increases for middle-class families look "relatively small" from the celestial vantage of the IMF, but politicians closer to the voting booths are not lining up to support this levy. Indeed, individual accounts have become thinkable – even necessary – because the "relatively small" changes aren't happening.

Those who keep insisting that only very modest changes are needed for Social Secur-



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ity as it stands, but find it impossible to enact them or even to advocate them aggressively, deserve to lose their credibility as critics of alternate plans. Social Security's long-term financial problems have been apparent for a decade. If a politician or a pundit hasn't been prominently advocating substantially higher payroll taxes and lower benefits that would kick in almost immediately, then he or she is in no position to label individual accounts as irresponsible or immoral.

Individual accounts are also a political necessity for transforming Social Security into a "funded" program – that is, a program that puts aside money in the present for future benefits, rather than promising that future benefits will be paid by future taxpayers. If Social Security were a private pension fund, according to the president's commission it would presently need to have $12 trillion stored up now, and earning interest, to pay off its promises to current workers and retirees. Instead, the trust fund currently holds about $1 trillion.

In theory, Social Security could build up a much larger trust fund by raising near-term taxes or cutting benefits. But I doubt the political system could handle it. Imagine if Social Security were fully funded right now, so that the trust fund held $12 trillion in assets. Total federal debt owned by the public is now about $3.4 trillion, so even if the trust fund bought every single federal government bond, it would need to buy trillions of dollars of other assets as well. This sum is so vast that it would almost necessarily need to be spread between corporate stocks and bonds, state and local bonds, real estate, and perhaps even foreign investments. In many or all of these markets, the U.S. government would become the single most prominent investor.

It is widely agreed that it would be disastrous for the U.S. political system to micromanage trillions of dollars in investments, whether this involved steering the money to specific companies or locations according to deals cut in the corridors of Congress, or attempts by Congress to prop up the stock

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market in lean times. But for how long would Congress keep its hands off if the Social Security trust fund were invested in a company that is accused of violating environmental laws, or conducting a racist hiring policy, or having a subsidiary that trades with Cuba or Iraq – or if it simply announced plans to lay off some workers? Could Congress have left alone a $12 trillion Social Security trust fund during these last few years if, as the stock market declined, a series of newspaper headlines screamed: "Social Security Trust Fund Lost $100 Billion in the Stock Market Last Month"?

Say all you want about how institutional arrangements can reduce political pressure. Government pledges not to meddle with a fund that holds trillions of dollars are by their nature not credible. Having the money in individual accounts is the best political insulation available.

Moving Social Security toward an actuarially funded program is important for an old-fashioned reason, too: it would increase national savings. Since the pioneering research of Martin Feldstein back in the 1970s, a number of studies have shown that a dollar of expected Social Security payments leads Americans to reduce their level of personal savings by about 50 cents. In the last few years, America has managed to combine low savings and rising investment by borrowing the money from abroad. This combination has worked fine in the short-term. But the jury is still out on whether a rapid withdrawal of these funds could wreak serious damage on the U.S. economy.

It would be foolish to bet America's economic future on the hope that the rest of the world would voluntarily fund U.S. investments in perpetuity. A pattern of capital consistently flowing from capital-poor countries, where the marginal returns on investments should be quite high, to a capital-rich country like the United States, where the marginal returns should be lower, is historically anomalous. Most countries, most of the time, rely heavily on domestic savings for their investment funds. Moving America's public retirement system in the direction of full funding is thus a sensible investment in America's long-term economic health. Full funding of Social Security also means that the long-term solvency problem would stay solved, so that Social Security wouldn't need to be saved again every couple of decades.

**Government pledges not to meddle with a fund that holds trillions of dollars are by their nature not credible. Having the money in individual accounts is the best political insulation available.**

Individual accounts as a supplement to Social Security also offer advantages in terms of flexibility and responsibility. As the elderly population grows, its diversity grows, too. The elderly include the "young old" and the "old old," the disabled and the active, the sick and



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the healthy, marrieds and singles, employed and unemployed. People retire with greatly varying hopes and expectations for the future: spending money sooner, planning to spend it later, or wanting to leave a bequest. They run up against different needs for spending money sooner or later, depending on health and family circumstances.

But public pension programs have a hard time allowing many degrees of flexibility. They set ages when a discrete event called "retirement" happens, and specify the levels of payments to be received at such time. Individual accounts could offer far greater flexibility to an elderly population that is increasingly heterogeneous.

A final argument for individual accounts is that citizens should take greater responsibility for their personal finances. Social Security is by its nature opaque and nonparticipatory. It's hard to figure out the link from your contributions to your benefits – especially since Congress can and does change the program. Individuals have no choice about how much to pay in or how the money is invested, and only a very limited choice (through choosing a retirement age) about how benefits will be paid out. By contrast, almost any form of individual accounts would require greater individual participation, which in turn would make people more aware of the links between the act of saving and their own financial status.

## NOT A MANTRA

Opponents of individual accounts sometimes like to argue that Social Security is good because it is a public and collective way of looking after each other, while individual accounts are a poor idea because, well, they are private and individualistic. While this argument reveals something about attitudes toward government, it offers only a caricature of what individual accounts are likely to be.

Individual accounts to supplement Social Security are unlikely to be truly private in any ordinary sense of the word. Most versions would mandate levels of contributions (although they may also allow people to opt out altogether and remain with the current system if they wish). Most plans include subsidies for those with low incomes. Every version would limit the kinds of investments that could be made, so that no one would be able, under pressure from a brother-in-law or a telemarketer, to toss their nest egg into somebody's scheme for converting water into gasoline. Most proposals for individual accounts include rules about withdrawals, often requiring the purchase of at least a small annuity and limiting the size of lump sums that could

**Almost any form of individual accounts would require greater individual participation, which in turn would make people more aware of the links between the act of saving and their own financial status.**



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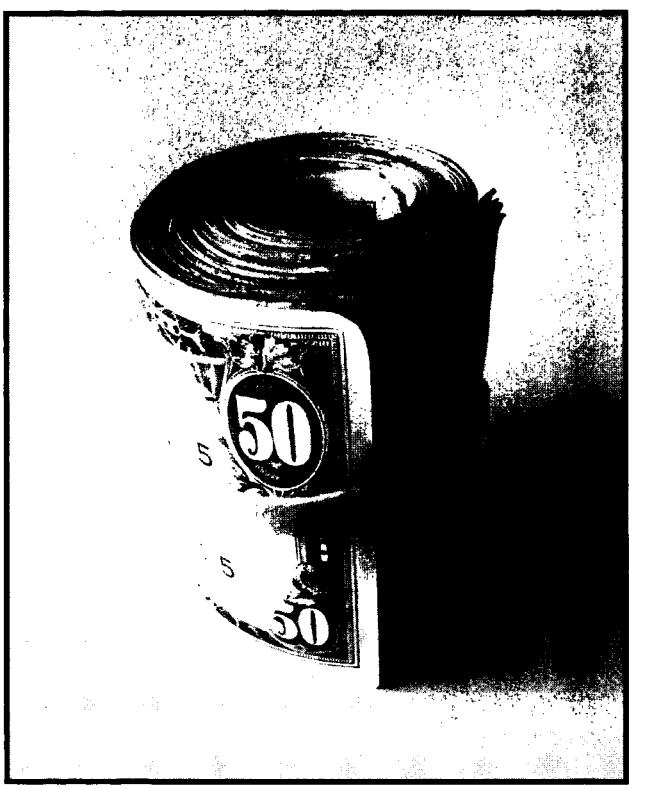
be withdrawn.

This list only scratches the surface of the rules that would be certain to accompany individual accounts. How would accounts be divided between divorced couples? How would the accounts be applied to child support? Could balances be pledged as collateral for a loan? Could they be drawn upon to satisfy a legal claim? Could they be used to repair a home in the aftermath of a natural disaster? As such accounts grow in size, some member of Congress is sure to propose that the individual accounts should be available for uses like a down payment on a house or college tuition.

Government rules – collective rules, if you prefer – would encircle individual accounts like great coils of rope. The argument for individual accounts as a supplement to Social Security begins from the assumption that society needs to make a collective decision over how to ensure that people make reasonable provision for their old age. The practical question is over the best mechanism for addressing this goal, given the reality that we are inheriting a Social Security system that is insolvent in the long term.

For six decades, Social Security has been one of government's biggest success stories, dramatically improving the economic well-being of the elderly. It is no attack on this magnificent legacy to point out that the program, as designed in the depths of the Great Depression, is not especially well suited to contemporary challenges. After all, when Social Security became law, those over 65 numbered only 7 percent of the population; by 2030, one in five Americans will be over 65. The nature of what it means to be elderly has changed dramatically in terms of life expectancy, health and expectations about working, and is bound to change further still.

For anyone with a life expectancy of more than 37 years, Social Security as presently constituted offers a contract that its own actuaries staunchly inform us cannot be honored. Harsh political conflicts in which Social Security is pitted against the rest of the budget will occur well before 2038; indeed, a mild version of this conflict has already surfaced in the arguments about the "lockbox" and whether the federal budget surplus should be at least as large as the Social Security surplus each year. Individual accounts aren't a mantra that, through sufficient repetition, will fix the U.S. public pension system. But they do offer a mechanism that could enable America to say, with a clear conscience, that the promises of Social Security will be kept. M

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# September

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# 11, 2001

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# Assessing the Costs of Terrorism

*by Peter Navarro and Aron Spencer*

How much will the worst terrorist attack in history cost America? The answer will surely be in the range of hundreds of billions of dollars – and could well hurdle into the *trillions.*

While this article does offer preliminary estimates of the direct and indirect costs of the attack, pinning down the numbers is just one reason – and not the most important reason – to make the reckoning. For the ultimate impact of the tragedy of September 11 depends on policy choices that have yet to be made. Such choices range from the nature of the military response, the methods used to increase domestic security, as well as the means used to compensate the families, industries and localities affected.

Arguably the most critical choices, though, will be the ones that affect the economy as a whole – in particular, government fiscal and monetary policy, and potential instability in world energy markets. For while a proper accounting of the short run costs of the attack



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**EXHIBIT 1: COST CATEGORIES FOR TERRORIST ATTACKS**

**THE IMMEDIATE AFTERMATH**

- Property damage
- Loss of human life and injuries
- Lost economic output
- Reduction in stock market wealth
- Psychological impacts of terrorism

**LONGER TERM MICROECONOMIC EFFECTS OF A "TERRORISM TAX"**

- Increased airline security
- Other security measures

**SECTOR-SPECIFIC IMPACTS**

- Advertising
- Airlines
- Insurance
- Hotel and tourism

**GOVERNMENT BAILOUTS AND BUDGETARY IMPACTS**

- The airlines
- New York City
- Reduced federal, state and local tax revenues

**THE HIGHER OIL PRICES-WEAKER DOLLAR CONUNDRUM**

- Effects of an oil price shock
- Costs of a weaker dollar
- Destabilization of the stock market and international monetary system

**MACROECONOMIC COSTS**

- A deeper recession
- A more volatile business cycle
- A lower long-term growth path and economic stagnation

yield mind-numbingly large figures, the damage promulgated through inflation, unemployment and lower productivity could dwarf the numbers linked to loss of property and life. Indeed, if the President, the Federal Reserve and Congress make imprudent policy choices, we may wind up on a slower growth track, with attendant hardships for tens of millions of Americans.

Exhibit 1 summarizes the broad categories of costs examined here. These range from property damage, to an economist's accounting for the loss of human life, to the aforementioned long-term drag on productivity and growth.

## PROPERTY DAMAGE

It will be months before a full accounting of the property destroyed or damaged by terrorists on September 11, 2001 is possible. Exhibit 2 provides a preliminary reckoning, based on a combination of published reports and constrained guesswork.

The big-ticket items include the loss of four civilian aircraft valued at $385 million, the destruction of major buildings in the World Trade Center with a replacement cost of from $3 billion to $4.5 billion, damage to a portion of the Pentagon that will cost up to $1 billion to fix, and cleanup of the hundreds of thousands of tons of rubble at the crash sites for another $1.3 billion.

In addition, New York's World Financial Center, 30 West Broadway, 22 Cortlandt Street, the Bankers Trust building, and 30 West Street suffered severe, but repairable, damage. Estimates of the cost of repair to these buildings are not yet available.

The terrorist attack took a very heavy toll on public works and infrastructure. Fire trucks, ambulances and police cars with an approximate value of $35 million were lost in the destruction. Streets were damaged, as were public utilities and subway infrastructure. We estimate the loss in the range of $2 billion.

Finally, 120,000 workspaces were destroyed. TowerGroup Technology estimates

**PETER NAVARRO** (http://www.peternavarro.com) is an economist at the Graduate School of Management, University of California (Irvine) and the author of ***If It's Raining in Brazil, Buy Starbucks: The Investor's Guide to Profiting from News and Other Market Moving Events.*** **ARON SPENCER** is a PhD candidate at UC (Irvine). Dr. Frank Harris helped significantly as did volunteer MBA students from UC (Irvine): Judy Allen, Holly Anderson, Carl Kim, Mike Kim, Ali Mogharabi, Arash Namvar, Indira Renduchintala, Sunny Sang and Michael Slater. A special thanks to Richard T. Carson for his assistance.



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computer hardware losses at $1.7 billion, with software/network losses at $1.5 billion.

### LOSS OF HUMAN LIFE

The terrorist attacks claimed upward of 6,000 lives, in total. Some 266 innocent lives were lost on the four downed aircraft. An additional 125 are dead in the Pentagon. The New York City toll is listed at more than 5,000 missing or confirmed dead.

In the most profound sense, there is no way to translate life in dollars. If you ask people how much they would pay to avoid a fatal accident today, the typical answer is everything they have.

Still, people don't behave as if their lives are infinitely valuable: they drive cars, use dangerous tools, sleep in houses without sprinkler systems, and engage in myriad other activities that increase the risk of premature death in return for pleasure or income or savings. And economists infer value to life by multiplying the financial gains associated with bearing marginally greater risk by the probability of fatality associated with the risk.

Consider two crude examples. If a construction worker is willing to accept a 1 percent chance of a fatal accident over his working life in return for $50,000 more lifetime pay, he is implicitly valuing his own life at $5 million ($50,000 divided by .01). If a homeowner refuses to install a carbon monoxide detector that costs $30 near her gas heater, thereby increasing the risk of dying by one chance in 10,000, it implies that she values her life at no more than $3 million ($30 divided by .0001).

Estimates based on a variety of risk-taking/risk-avoiding activities generate remarkably consistent numbers. Kip Viscusi of Harvard puts the value of human life at between $3 million and $7 million – numbers that are now used by the federal government in deciding whether to mandate additional safety

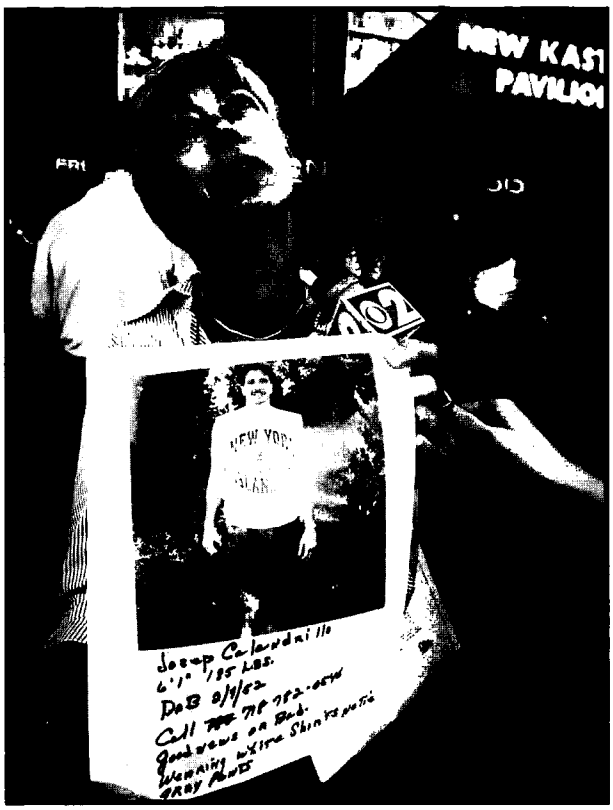


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**EXHIBIT 2: PROPERTY DAMAGE FROM TERRORIST ATTACKS**

| | COST |
|---|---|
| **MAJOR BUILDINGS** | |
| Buildings destroyed in World Trade Center complex | $3.0 billion to $4.5 billion |
| Pentagon damage | $250 million to $1 billion |
| Cleanup of rubble from crash sites | $1.3 billion |
| **AIRCRAFT** | |
| Four passenger jets | $385 million |
| **PUBLIC WORKS AND INFRASTRUCTURE** | |
| Fire trucks, ambulances, police cars | $35 million |
| Infrastructure such as streets, sewer, utility lines and subways | $2 billion |
| **CORPORATE PROPERTY** | |
| Office equipment and software | $3.2 billion |
| **TOTAL** | $10 billion to $13 billion |



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equipment in commercial aircraft. Not surprisingly, the value that people implicitly place on their own lives rises with income and education.

Assuming most of those lost in New York will fall at the higher end of the education and income scales, and that there is considerable collateral damage to their families in the form of emotional pain and income loss that is not included in how people value their own lives, the 6,000-plus death toll translates into an economic cost in the range of $40 billion.

### LOST ECONOMIC OUTPUT IN THE IMMEDIATE AFTERMATH

Exhibit 3 (page 22) offers estimates for the major categories of lost economic output.

In response to the crisis, the entire air



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transportation network was shut down for two-and-a-half days at a cost of almost $1.5 billion in lost airfares and cargo-shipping revenues. Federal Express lost $100 million in just 48 hours and presumably other courier services such as UPS lost tens of millions as well. Numerous small aviation enterprises, from crop dusters to traffic helicopter services, likewise sustained significant losses. In addition, the major carriers are projected to lose another $3.4 billion to reduced demand by the end of September, for a total approaching $5 billion.

The hotel industry suffered numerous room cancellations, at a loss in revenues of $700 million. Television and radio stations running commercial-free coverage lost roughly $1 billion in foregone advertising revenues



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**EXHIBIT 3: LOST ECONOMIC OUTPUT IN THE IMMEDIATE AFTERMATH**

| CATEGORY | LOSS |
|---|---|
| Lost airline and cargo shipping revenues, September 2001 | $4.7 billion |
| Lost hotel industry revenues through first weekend of crisis | $700 million |
| Lost advertising revenues in television and radio during commercial-free coverage in the first days | $1 billion |
| Two-day partial work stoppage and loss of productivity | $35 billion |
| Lost consumer spending and retail sales | $6 billion |
| TOTAL | $47 billion |

**EXHIBIT 4: LOSS OF STOCK MARKET WEALTH**

| | DROP IN INDEX AS OF SEPTEMBER 21 | LOSS IN MARKET CAPITALIZATION |
|---|---|---|
| NYSE (U.S.) | -11.24% | -$1.3 trillion |
| Nasdaq (U.S.) | -16.05% | -$407 billion |
| Amex (U.S.) | -8.01% | -$8.5 billion |

in a matter of days. Newspapers suffered a double squeeze of increasing the pages of coverage while dramatically decreasing ad space; magazines were also hard hit.

Golf tournaments, baseball games, college and professional football games, and numerous other sporting and entertainment events were cancelled or postponed. We can only guess at these impacts, though surely the loss exceeds $100 million.

A two-day partial work stoppage and attendant loss of productivity, as the nation adjusted to the shock, likely cost another $35 billion. Consumer spending fell by a reported 20 percent in smaller cities and 50 percent in larger ones in the two days following the attack, for a loss of retail sales around $6 billion.

We acknowledge that these numbers must be taken with a healthy dose of skepticism. Gross revenues lost by retailers, for example, are surely larger than the opportunity cost of the labor and capital services that would have been used to produce the revenues. And, in any event, there is clearly an element of double-counting in adding the market value of the labor lost to the retail value of the goods and services not sold.

On the other hand, there is an element of undercounting here, too. The market value of goods and services not sold represents a lower bound on their value to consumers – a day at Disneyland may be worth $500, even though the price of admission and assorted souvenirs is just $100. We reiterate: the point of this admittedly rough exercise in social accounting is to put the losses in useful context.

## SHORT RUN REDUCTION IN STOCK MARKET WEALTH

Exhibit 4 lists the percentage drop in the major U.S. stock market indices and loss of market capitalization from the close of the markets on Monday, September 10 to Friday, September 21 – the end of the first week of trading after the attack.

The New York Stock Exchange and the Nasdaq, which list the lion's share of large, publicly traded corporations, suffered double-digit drops. This translates into a total loss of stockholder wealth, as measured by the reduction in market capitalization, of a staggering $1.7 trillion.

In addition, shareholders in other major markets around the world likewise suffered substantial losses as of September 21. These foreign exchanges fell from a minimum of 6.3 percent for the Nikkei to well over 10 percent for all of the major European exchanges, with the German exchange falling by almost 20 percent.

Is the drop in the market value a measure of cost? In one sense, it may be the best single



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measure of the losses to the owners of capital linked to the physical damage, the expected decline in corporate profits associated with macroeconomic instability and – most elusive – the greater risk premium investors now attach to the ownership of equity.

Again, though, we acknowledge the element of double-counting: you can't legitimately add lost revenues to the airline or hotel business to the decline in the market capitalization of the two industries. But measuring the decline in stock values is surely worth doing since it gives some sense of how much damage investors believe has been done to their future claims on corporate income.

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## PSYCHOLOGICAL IMPACTS OF TERRORISM

The worst terrorist attack in American history exacted a grave emotional cost to Americans who were not directly affected. This terror, and the attendant perceived loss of freedom to travel and work without terrorism's risks, imposes a heavy psychological impact – precisely as it was intended.

The question, of course, is how we might put a value on these intangible costs. One way would be to apply what economists call "contingent valuation" (CV) analysis. CV analysis uses survey methods to assess the willingness of people to pay for goods not regularly traded in the marketplace. Such "non-market goods" include cleaner air and water, a reduction in nuclear power plant radiation risk, and broader public safety concerns. Thus, in the wake of the Exxon Valdez oil spill, the State of Alaska commissioned a survey in which Americans were asked how much money they would have been willing to pay collectively to undo the damage. The (very controversial) answer: $3 billion.

In this particular case, the question is: How much would we pay to be able to fly (or work in large office buildings, or drink the water from public reservoirs) without fear?

The emotional cost of the attack on the World Trade Center surely dwarfs that associated with thinking about all those dead birds and oil-drenched sea otters in Alaska. But by what order of magnitude? Hypothetically, if each of the 100 million American households



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not living in poverty would give up a mere $1,000 to be able to forget that Osama Bin Laden and his ilk walk the earth, the emotional damage must be equivalent to at least $100 billion.

### MICROECONOMIC IMPLICATIONS OF THE TERRORIST TAX AND DEFENSIVE BEHAVIOR

Rachael Carson's *Silent Spring*, released in 1962, marked an important turning point in public awareness about the dangers of environmental pollution. The result was the birth not only of a new government bureaucracy – the Environmental Protection Agency – but also a plethora of new government regulations. While these regulations had the salutary effect of cleaning up the nation's air and water resources, they also imposed a burden on the nation's productive capacity. Indeed, we would argue that the new regulation turned out to be just one of a number of supply-side shocks to the economy that created irreconcilable conflicts between Americans' expectations of rising living standards and the reality of reduced productivity growth in the 1970s – conflicts that led to "cost-push" stagflation of the era.

The September 11 terrorist attacks promise to give rise to a comparable regulatory response that creates a drag on productivity. The important lesson here from the 1970s is that brute-force responses to real problems can lead to great harm. It took the environmental bureaucracy many years to shift from unnecessarily expensive "command and control" systems of pollution abatement to more highly targeted and economically efficient methods. Will the nation again waste vast sums in the pursuit of legitimate public goals?

America faces two different kinds of terrorist threats to civil aviation. The first is the "Lockerbie problem" – the destruction of aircraft by bombs. The second is the hijack of aircraft for use as weapons of mass destruction or, as in the past, as collateral for ransom. At present there are a number of policy options on the table to address these problems – all of which potentially impose very high costs. These options, and their microeconomic impacts, are summarized in Exhibit 5.

**EXHIBIT 5: THE MICROECONOMIC COSTS OF "TERRORIST TAX"**

| | COST |
|---|---|
| Sky marshals | Up to $6 billion per year |
| Government takeover of airport security | $1 billion per year |
| Retrofitting of aircraft with anti-terrorist devices | $450 million |
| New technology "fixes" | $2 billion per year |
| Increased airport delays | $8 to $32 billion per year |
| **TOTAL (FIRST YEAR)** | Up to $41 billion |

One option is to post sky marshals on every plane flying in the U.S. At present, the U.S. government employs 500 sky marshals. Simply doubling the sky marshal force would cost roughly $100 million. At the other end of the spectrum, we could put two such marshals on every plane flying in the U.S. This would require some 40,000 additional marshals. It would also lead to the creation of a bureaucracy many times the size of the FBI. The annual cost would be roughly $6 billion.

A second proposal is to replace private airport security with a government force, one presumably managed by the same bureaucracy as the sky marshals. The implicit rationale for this reverse privatization is that it is very difficult to create an incentive structure for private security forces that leads to optimal levels of security delivered at least cost.

Government employees, the argument goes, would be paid far more than the rent-a-



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guards who now screen passengers, and it would thus be easy to recruit more qualified employees. Assuming the current force of roughly 18,000 guards was increased to 25,000 and that the average salary was increased from approximately $15,000 a year to a government pay scale of $35,000 a year, the wage bill alone would rise by $600 million annually. With additional overhead of a government security force, the net cost increase would surely approach $1 billion annually.

A third policy option is to retrofit every plane with a reinforced cockpit door and to require all new planes to adopt the Israeli configuration of two reinforced doors to the cockpit. The retrofits alone would likely cost $50,000 per plane, for a total of roughly $450 million.

U.S. regulators will no doubt also look at more sophisticated new technology fixes. These range from the use of computers to take control of flights seized by terrorists to more sophisticated 3D baggage scanners, face-recognition systems, and biometric identity devices, such as retinal and fingerprint scanners. Equipping the nation's roughly 9,000 commercial aircraft and 50 largest airports with an array of these technologies could cost as much as $2 billion.

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Big numbers? Perhaps. But even the upper-bound numbers work out to just $20 to $25 a ticket. Moreover, if these measures were sufficient to restore enough confidence in the American public so that airline travel reached its previous levels, the cost per ticket could fall below $20.

The real worry is that the intangible costs associated with increased airport security will be ignored and, as a result, too little attention will be paid to passenger convenience,



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permanently burdening the airline industry with unnecessary delays. Assume that airline traffic falls by the 20 percent now projected by the airline industry. This would reduce the number of annual passenger trips in the United States to 525 million. If each traveler must arrive 90 minutes earlier, as recommended by the FAA, the cost in additional travel time would be 788 million hours.

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What value should we put on that time? Surveys and behavioral-based studies suggest people place a value of about $10 per hour on time spent in their cars, while studies of air travel put the cost at two to four times that much because air travelers have higher average incomes. Accordingly, we estimate the value of the 788 million hours lost to be somewhere between $16 billion annually (valuing time at $20 an hour) and $32 billion annually (valuing time at $40 an hour).

Note, at this point, that we have only considered the costs of increased security for our nation's airports. In fact, there will be considerable expenditures by federal, state and local governments as well as by private corporations to beef up security at national monuments, government buildings, nuclear power plants, water treatment plants, sports stadiums, high-rise office buildings, concert halls and any place where large numbers of people gather and are vulnerable to a terrorist attack. No estimates for these efforts are presented here, but the increase is likely to run into the billions – and many times more if security procedures waste work and recreation time.

## LONGER TERM SECTOR-SPECIFIC COSTS

The four sectors likely to bear a large brunt of the attack will be the advertising, airline, insurance and hotel/tourism industries. Of the four, only the insurance industry apparently has the resources to ride out the storm without great dislocation.

As noted earlier, advertising-based media



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lost as much as a billion dollars in revenues within just a few days of the attack. More broadly, industry analysts now project a 6.6 percent decrease in ad revenues for the remainder of 2001 and a 7.4 percent drop during 2002. Taking into account that part of these decreases were due to recessionary conditions prior to the attack, we value the net drop at about $5 billion.

The airline industry is projecting a 20 percent reduction in demand beginning in the fourth-quarter 2001. This translates into a loss of just under $20 billion in the industry's contribution to the gross domestic product on an annual basis. It is unclear when demand may resume its growth, or whether the labor and capital freed by this industry shrinkage can be productively used elsewhere in the foreseeable future. Much will depend on the course of events and the policies adopted for improved airline security.

Similarly, the hotel and tourism industries are hunkering down for a projected 20 percent decline in demand through fourth-quarter 2000 at a revenue loss of $5.5 billion. This is on top of the $700 million lost in the four days following the attack.

Longer term, demand for hotel rooms is projected to drop in 2002 from its pre-attack levels at a rate between an optimistic 3 percent decline to a more pessimistic 10 percent decline. This translates into an additional $3 billion to $11 billion in lost revenues.

In addition, the effects will ripple downstream to the construction industry, as fewer of these facilities will be built. In the worst-case scenario, virtually all large hotel projects will be put on hold for several years at a cost in foregone construction revenues of about $12 billion. Again, it is unclear what portion of the labor and capital freed could be productively used in other industries.

Turning to the insurance industry, the terrorist attacks only accelerate a trend: insured catastrophic losses have been rising dramatically over the past several decades. Exhibit 6 summarizes some of those insured losses (adjusted for inflation) for catastrophes ranging from earthquakes and riots to hurricanes and terrorist bombings.

**EXHIBIT 6: INSURED LOSSES FROM OTHER DISASTERS**

| CATASTROPHE | INSURED LOSSES |
|---|---|
| 1989 Hurricane Hugo | $5 billion |
| 1992 Los Angeles riots | $844 million |
| 1992 Hurricane Andrew | $16.9 billion |
| 1993 World Trade Center bombing | $542 million |
| 1994 Northridge, California earthquake | $13 billion |
| 1995 Oklahoma City bombing | $127 million |

Note that two major hurricanes – Andrew and Hugo – resulted in losses of well over $20 billion, while the previous World Trade Center bombing generated claims of $542 million and the Oklahoma City bombing generated claims of $127 million. Hurricane Andrew did force some insurance companies into bankruptcy. But that was the exception; the industry tends to pool its vast resources through reinsurance schemes.

Congress has limited the liability of the airlines (and their insurers) in the events of September 11. The airlines' liability has capped at the level of insurance at the time of the attacks – $1.5 billion per airline for American and United, with a $500 million deductible each.

In addition, these companies would be responsible only for the deaths of passengers. With the death count on board at 266, this amounts to roughly $11 million per life lost, with the airline companies responsible for the first $1 billion of the payouts.

For persons killed on the ground, analysts estimate that an average of $500,000 will be awarded to the families of each of the victims.



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The actual amount per family will vary greatly. We estimate that the total bill for lives lost on the ground is somewhere on the order of $3.25 billion.

Someone must pay for expected changes in future risk. If premiums on business insurance of all types rise by an average of 5 percent, America's annual insurance bill will rise by $8 billion. Of course, if claims don't rise accordingly, the $8 billion represents a transfer of income to the insurance industry – not a real cost to the economy.

### GOVERNMENT BAILOUTS AND LOST TAX REVENUES

Congress has approved a bailout of $18 billion for the airlines. Of that, $5 billion is in cash subsidies, $10 billion is loan guarantees, and $3 billion is in aid for increased security costs. Since loan guarantees represent modest costs to the government – the difference between the cost of capital to Uncle Sam and the cost of capital to the industry – we limit our analysis to the other items.

The City of New York will surely receive massive aid from the federal government. At the time of this writing, there were no reliable estimates of the size of the aid package – Gov. Pataki is asking for $54 billion – but it will certainly run into the billions.

On the other side of the ledger, federal, state and local tax revenues will all drop by a substantial amount. For the federal and state governments, this will come in the form of reduced corporate-tax receipts both from corporations operating in the affected sectors and, more broadly, through the recessionary effects that will be discussed further below. As an example of the many and varied ways the September 11 attacks will ripple through the budget, we are likely to see an extraordinary rise in deductible charitable contributions. This will, in turn, lower federal and state tax receipts.

For local governments, the reduction in hotel-room demand will result in an appreciable drop in hotel-room taxes, which average about 12 percent of the room rate. Such taxes constitute a significant fraction of local government revenues, particularly in major tourist destination cities like Boston, San Francisco, San Diego, Seattle and Miami. We estimate that the projected 3 percent to 10 percent drop in hotel room demand in 2002 will result in the loss of $400 million to $1.3 billion in such local tax revenues.

Note that, as a first approximation, government transfers and reduced tax revenues represent no net economic losses; they are matched, dollar for dollar, by reduced liabilities to the individuals, corporations and localities affected by the terrorist attacks. But looking closely, there are bound to be real (if difficult to measure) losses associated with the transfers. For example, the value of the services that a local government cuts – say garbage collection or after-school programs – will probably exceed the monetary gains to the tourists who have cancelled their trips and thus don't pay the tax.

### THE HIGHER OIL PRICE – WEAKER DOLLAR CONUNDRUM

Oil prices spiked after the terrorist attacks on fears of war in the Middle East. Within days, however, prices fell to levels below the attack level because of offsetting concerns about recession and a weakening demand for oil.

As of this writing, it remains to be seen whether oil prices will again spike in the wake of military action in Afghanistan or elsewhere. While a military strike or sabotage might disrupt the oil flow, the greater risk is a collapse of cooperation with Persian Gulf oil producers that leads to production cutbacks



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like those experienced in the 1970s.

Such an embargo would likely be organized by oil-exporting countries, like Iraq, Iran and Libya, that are hostile to America. However, any successful oil embargo would probably require the cooperation of the Middle East's largest oil producer, Saudi Arabia. The Saudis account for half of the oil production from the Mideast. More relevant, they have the production capacity to offset any reduced output elsewhere in the region.

At the time of this writing, it is impossible to predict how events will unfold. Let us simply note that for every dollar increase in the price of a barrel of oil, America's oil import bill rises annually by roughly $3.4 billion. Moreover, higher oil prices ripple pervasively through the economy as American energy producers raise their prices and energy-intensive sectors – from aluminum to plastics – face higher production costs. If government copes as badly with the resulting dislocations as it did in the 1970s, the real cost would be many times greater than the transfers to energy producers.

The terrorist attack has, at least initially, also weakened the exchange value of the dollar. While the root cause is difficult to determine, foreigners fearing war and instability may be pulling their money out of U.S. financial markets. As investors redeem dollar-denominated assets, they exchange dollars for yen, francs or Saudi riyals, and the value of the dollar falls through the laws of supply and demand. Add to this the impact of rising oil prices. More dollars are required to buy the same amount of imported oil, and more dollars spent abroad likewise mean downward pressure on the dollar.

A weaker dollar does have the benefit of stimulating our export industries, offsetting some of the macroeconomic weakening linked to the terrorist attacks. However, it also is inflationary because it raises the cost of imports. A 10 percent drop in the value of the dollar would raise our import bill by roughly $140 billion.

There is a broader problem here, however,

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than simply a rising import bill. A weakening dollar that increases inflationary expectations would severely constrain the ability of the Federal Reserve to use expansionary monetary policies to fight recession. Moreover, a weaker dollar undermines the economies of our global trading partners as America imports fewer goods. The export-oriented economies of Asia – most notably Japan – are particularly vulnerable. That's why Tokyo tried – unsuccessfully – to prop up the dollar in the days after the attack.

In this regard, there is a much larger concern raised by the intricate relationship between rising oil prices and a weakening dollar. Consider this hypothetical chain reaction: a military response against the terrorists alienates oil producers; an OPEC boycott or other supply disruption raises oil prices; soaring oil prices drive down the dollar; a falling dollar creates domestic inflationary pressure; the fear of inflation constrains the Fed from further action; Fed immobility results in a drain of foreign dollars from the stock market; the departure of foreign investors drives down the stock market; the decline of markets creates a negative wealth effect that pushes the domestic economy over the edge to depression. This depression spreads globally first to Asia as a weakening dollar dramatically cuts Asian exports to the U.S. and then to Europe as the combined reduction in demand from the U.S. and Asia completely undermine the European economy.

Not plausible, you say, because policymakers have learned their lessons from the first two oil crises? You are probably right. Still...

## MACROENOMIC COSTS

Will the worst terrorist attack in history be recessionary or inflationary – or both? How will the attack affect the volatility of the business cycle and more importantly, long-run prospects for economic growth? In thinking about these questions, it is useful to examine the four key macroeconomic variables in Exhibit 7 for the very good times of 1993 to 2000 and the very bad times of 1974 to 1982.

**EXHIBIT 7: KEY MACROECONOMIC VARIABLES IN BAD TIMES AND GOOD**

| | 1974-1982 | 1993-2000 |
|---|---|---|
| Growth | 1.98% | 4.04% |
| Inflation | 7.84% | 1.85% |
| Unemplomentent | 7.24% | 4.96% |
| Non-farm productivity | 0.88% | 2.14% |

From 1993 to 2000, the U.S. economy demonstrated its full potential in a world of stable prices, reduced demand for military goods and services, and the rapid diffusion of exciting new technologies. Comparing this period to 1974-82, we can see that productivity growth was substantially higher – 2.14 percent versus 0.88 percent. Inflation was virtually nonexistent – 1.85 percent versus 7.84 percent. The unemployment rate was remarkably low – less than 5 percent compared to more than 7 percent. By no coincidence, the economy grew, in real terms, twice as rapidly as in the 1974-82 period – and half a percent higher than the historical average of 3.5 percent.

The very bad times of 1974-82 were initiated by a war and an over-expansionary fiscal policy in the 1960s, and compounded by supply-side shocks in the early 1970s. Moreover, the Federal Reserve added to the dislocation by gyrating between contractionary and expansionary measures. These factors led to a growth rate a full percent lower than the average of the previous 50 years.

The risk today is that we are witnessing the beginning of a similar series of destabilizing actions and reactions that could undermine



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the business climate and push the U.S. economy back into a 1970s-style era of stagflation and hard times. This need not be the case. Nonetheless, there is at least one plausible nightmare scenario, which does not turn on the aforementioned possibility of an oil crisis.

In stage one of that scenario, which plays out over the next several quarters, the macroeconomic shocks of the attacks – lost production in the immediate aftermath of the attacks, plunging consumer confidence and a sharp drop in retail sales, a dramatic reduction in business investment, a negative "wealth effect" from a declining stock market, and so on – all conspire to push the U.S. economy into a deep recession. During this stage, the Federal Reserve responds with an expansionary monetary policy, while the Federal government engages in a variety of actions that effectively serve as a very strong dose of expansionary fiscal policies – the bailout of the airlines, aid to New York City, increased defense expenditures.

Collectively, this sharp dose of expansionary fiscal and monetary policies pulls the economy out of the recession at a rapid pace – a pace that sets the stage for increased inflationary pressures. Within a year or two, the economy overheats in much the same way it did in the late 1960s during the Vietnam War. At the same time, massive expenditures on increased domestic security create additional cost-push pressures in much the same way the new environmental and workplace regulation did in the 1970s.

The stagflation of the 1970s was, in essence, purged by draconian changes in monetary policy in 1980-81 that triggered a brief but very harsh recession and by a changing regulatory climate under President Reagan that sharply increased business investment. If we are once again caught in doleful 1970s-like circumstances, there is no guarantee that the nation could summon the political will to snap back. And without it, the long-term capacity of the economy to grow could be reduced sharply. Imagine, for example, that instead of growing at an average of 3.5 percent annually for the next decade (a half a percentage point less than in the 1994-2000 period), the economy only managed to grow at 2.0 percent – as in the 1970s. Instead of a real GDP of $14.4 trillion in 2011 (in 2001 dollars), GDP would only reach $12.4 trillion – a difference of *$2 trillion*!

## THE FINAL RECKONING

We've attempted a preliminary assessment of the costs of the worst terrorist attack in history. Counting the value of lives lost as well as property damage and production of goods and services forgone, the United States has already suffered losses exceeding $100 billion. Including the loss in stock market wealth – the market's own estimate arising from expectations of lower corporate profits and higher discount rates for economic volatility – the price tag approaches $2 trillion.

The more important conclusion from this article, however, is that the full picture has yet to be painted. The ultimate economic cost of the tragedy will turn on how successfully policymakers cope with new challenges. On one level, they risk investing too little in resources that could minimize the intangible (but very costly) inconveniences associated with the need for increased security. On quite another level, they must deal with the potential for increased volatility in the business cycle that could reduce the economy's growth potential. The stakes here are simply breathtaking – failure to prevent 1970s-style stagflation could reduce the GDP by trillions annually.

Indeed, if Washington overreacts to this crisis or makes imprudent policy choices, the terrorists will have won their heinous war.



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*By David S. Evans*

# Is Free Software the Wave of the Future?

How's this for a way to organize a market? Let's all agree to work together to create a new product. I'll put in some effort and hope you and many others do, too. Once we've got a working prototype, we'll let anyone use it free. Of course, no one can possibly make money from the enterprise. But if everyone works together, we'll have some fun and end up with a great product we can all use.

Your typical economist would probably assume that she was listening to some latter-day Rip Van Winkle who didn't know that the events of the last decade or so – notably, the collapse of communism – had given utopian dreams a bad name. A more patient one might resist the inclination to make a dash for the exit and explain to our Haight-Ashbury refugee about the importance of property rights, free-rider problems and profit incentives in making things people really want at a cost that reflects the value of the labor and capital that go into them.

That economist, however, wouldn't have an easy job responding to the retort: so where do the Linux PC operating system and a lot of other distinguished software coming out of the open-source movement fit in this picture?

Linux, you might not recall, was not so long ago just a gleam in the eye of Linus Torvalds, a computer science student in Finland. He posted an early version of his nascent software code for a new operating system on the Internet and invited others to expand and improve it. Many programmers responded with enthusiasm. During the 1990s, Linux became one of the leading operating systems for servers – the computers at the heart of networks as small as the ones used by neighborhood hardware stores and as large as the Internet itself.

Linux, moreover, was not a flash in the pan. Several other software products

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that are widely used on Web servers – Apache and Sendmail in particular – arose from this anomalous cooperative approach. As with all "open source" software, anyone can get a copy of the underlying software code and, in most cases, use it for free.

Open-source software thus presents a fascinating puzzle to economists. If one described this method for producing software when Linus Torvalds was just another aspiring computer nerd, most economists would have predicted that it had zero chance of working – assuming they took the proposition seriously enough to prognosticate at all. Now that open source has generated unquestionable successes, economists are trying to understand why it works, how it works, how it is likely to evolve and what lessons it provides for other products. Herewith, a primer.

## OPEN-SOURCE AND PROPRIETARY SOFTWARE

Strictly speaking, "open source" refers only to the practice of making the source code for software available to others at no extra charge – although possibly with some restrictions on how they can use it or pass it on to others. Source code is what programmers actually write, using various programming languages. Linus Torvalds allowed anyone to use his original Linux code, so long as the user agreed to give others free access to any subsequent changes he made to the source code. Or, to put it crudely: he got for free and had to give back for free.

"Proprietary" software, by contrast, is sold like cars or telephone service. The entity that owns the rights sells licenses to use its intellectual property, guarding against theft either by not disclosing the source code or by restricting its use sufficiently to prevent the recipient from redistributing it.

Consider the most popular word processing programs over the 20-year history of the personal computer: WordStar, WordPerfect and Word. The vendors of these programs distributed them to customers in the form of machine code (not source code) under terms that prevented users from legally making copies for others. Machine code (sometimes called binary code or object code) is in a form that even experts cannot easily decipher. Vendors of proprietary software, including IBM, Sun, Oracle, Apple and Microsoft, also protect their rights by enforcing copyright and patent restrictions.

The issue of property rights in software has been simmering since the dawn of the computer age in the 1950s. Computer users wrote programs in the early languages, like Fortran, that often came with the big computers, and they often shared the results with others. Likewise, many of the early personal computer programs were created by hobbyists and distributed free.

But, although "shareware" or "freeware" programs have remained popular, the production of proprietary mass-market software exploded with the spread of PCs through homes and offices. Indeed, proprietary programs were important in most categories even when computers still numbered in the hundreds of thousands instead of the hundreds of millions. Among the early best-sellers: CP/M in operating systems, MS-Basic in computer languages, WordStar in word processing and VisiCalc in spreadsheets.

The recent success of open-source software – and the buzz around this method of production – resulted from several developments. First, several formal institutions were established to promote open-source software,

**DAVID EVANS is a senior vice president at National Economic Research Associates.**



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most notably the Free Software Foundation in 1985 and the Open Source Initiative in 1998. Second, open-source software became significantly easier to produce as a result of the growth of the Internet and the reduction in communication costs.

Third, servers – the computers that do the heavy lifting for computer networks – and the early Internet itself served as a primordial stew for open source. Many of the successful open-source products to date have resulted from the needs of "techies" who maintain servers. They want software with the source code available so they can fix glitches themselves. These successes include Linux (which accounted for an estimated 12 percent of operating systems on new servers shipped in 2000), Apache (which by some measures is now the most popular Web server software) and Sendmail (which is used on a majority of Internet mail servers).

**Most economists would have predicted open source had zero chance of working – assuming they took the proposition seriously enough to prognosticate.**

### SOFTWARE PRODUCTION AND THE ROLE OF INTELLECTUAL PROPERTY

In market-oriented economies, the owners of computer software can exercise intellectual property rights to protect their work. The creator of software can obtain a copyright, which enables the owner to limit the legal ability of others to copy or modify the work. Moreover, in some countries the creator can also obtain patents over techniques used in the software, further limiting the legal ability of others to use the knowledge embodied in software.

No less important, the software owner can maintain trade secrets much more easily than for written works in general. Source code is written in a computer language that is understandable to people trained in that language [e.g., "if (myNumber < 25) {myNumber = myNumber + 1}"]. But before it can be used, this source code must be translated into machine code that is understandable to the computer hardware, but terribly hard for humans to decipher. A program distributed in source code therefore can be readily modified or adapted for other purposes by a skilled programmer, while a program distributed in machine code cannot.

Note that both proprietary and open-source software programs have copyright (and sometimes patent) owners. In both cases, the owners license the use of the intellectual property in their software to others. But the licenses governing proprietary and open-source software use differ radically.

Proprietary software vendors use their property rights to prevent anyone from using the software without paying for it. And they are not bashful about going to court to challenge infringement. In perhaps the most famous software copyright infringement case, Apple sued Microsoft to prevent the use of a point-and-click graphical user interface in Windows. (Apple lost.)

Open-source adherents, by contrast, typically allow use of their intellectual property rights without cost to others. In general, an open-source license permits anyone to take the software, modify the source code and use



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or distribute the modified source code to others without paying the owners of the copyright. One type of license goes further, requiring that if a program is modified and distributed, the modified source code must be made available for free. That license, designed by the Free Software Foundation, enforces a kind of social compact among members of the open-source community and helps to advance the FSF's goal of making software free. Linux is licensed this way, as, apparently, is most open-source software.

In a nutshell, then, proprietary software owners use intellectual property rights to make profits by excluding nonpayers. Most open-source software owners use intellectual property rights to enforce agreements among participants.

The proprietary model is easily understood – it's about making money. Companies invest in the creation of software. They hope to realize a return on that investment by licensing the software to consumers, and possibly by licensing or selling the code to other software makers. The open-source method is not well understood, but it is clearly rooted in a complex constellation of incentives ranging from purely social (like participating in a club) to the profit-oriented by companies (like IBM) that see the success of open source as in their interests.

The proprietary model usually leads companies to organize software production through familiar hierarchical methods. Typically, a company anticipates consumer demand for particular software (possibly educated by consumer research). Software architects design it, programmers write it, testers identify bugs, and programmers fix those bugs. The major creative work for any software module tends to be done by individuals who are in close proximity.

Today's open-source model more typically relies on a decentralized production – what Eric Raymond, one founder of the Open Source Initiative, calls the "bazaar" as opposed to the "cathedral." A common method is to have a central committee (as for Apache) or a benevolent dictator (as for Linux) that determines the general design, identifies projects to be worked on and determines what modifications get incorporated in the "official" version of the open-source product. Individual programmers pursue these projects and possibly fix bugs in the software. They may also work on projects of their own choosing that result in modifications to the software. Communication is electronic, via e-mail and newsgroups.

### THE FSF'S GENERAL PUBLIC LICENSE

The Free Software Foundation opposes proprietary software on ethical grounds. As Richard Stallman put it, in reference to GNU, his operating system project, "Even if GNU had no technical advantage over Unix, it would have a social advantage, allowing users to cooperate, and an ethical advantage, respecting the user's freedom." The FSF promotes what it calls "free software" and disavows any support for the broader concept of open-source software.

The FSF is therefore not seeking to coexist with proprietary software, but to displace it. Although many other participants in the open-source community do not share the FSF's views, the General Public License (GPL) popularized by the FSF has been critical in shaping the open-source software industry. The GPL relies on the legal tools at its disposal – the rights of a copyright holder to decide how the copyrighted work is licensed – to encourage the expansion of open-source software and discourage the commingling of proprietary software with open source.



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The GPL requires that anyone who wants to distribute modified versions of software covered by the GPL must make the source code for the modified software available at effectively no charge. The FSF states:

> We encourage two-way cooperation by rejecting parasites: whoever wishes to copy parts of our software into his program must let us use parts of that program in our programs. Nobody is forced to join our club, but those who wish to participate must offer us the same cooperation they receive from us.

This forced sharing of modified code results from a feature of GPL dubbed "copyleft." The gist is captured in the following license clause:

> You must cause any work that you distribute or publish, that in whole or in part contains or is derived from the program or any part thereof, to be licensed as a whole at no charge to all third parties under the terms of this license.

The GPL is thus "viral" in the sense that any program making use of code covered by the GPL becomes code covered by the GPL. The GPL has not yet been tested in court. Thus, precisely what "derived from the program" or "based on the program" (another term used in the license) means is not settled.

The GPL is the source of considerable controversy among open-source software producers and their proprietary counterparts. Some open-source advocates believe the GPL retards the growth of open-source software by discouraging the development of proprietary software that can work with open source and by limiting the profit opportunities of companies, like Caldera and Red Hat, that want to promote open-source products. Proprietary companies – Microsoft has been the most vocal – have expressed concern that they risk losing their intellectual property rights if they make their proprietary software interoperate with software covered by the GPL.

Although the FSF has been quite influential, the open-source community does not speak with one voice. The Open Source Initiative was founded right after Netscape announced in early 1998 that it was going to release the source code for its Web browser. "We realized that the Netscape announcement had created a precious window of time within which we might finally be able to get the corporate world to listen to what we have to teach about the superiority of an open development process," explained Eric Raymond – that "it was time to dump the confrontational attitude that has been associated with 'free software' in the past and sell the idea strictly on the same pragmatic, business-case grounds that motivated Netscape."

To this end, the OSI has published a guide to the terms a software license should (and should not) contain in order to be considered open source, as well as a list of licenses that satisfy its definition of open source. In particular, it permits the removal of the "viral" aspect of the GPL by not requiring the redistribution of a modified program under the same license terms as the original.

One of the nonviral licenses that the OSI recognizes as open source is the Berkeley Software Distribution (BSD) license. A user who chooses to redistribute a BSD-licensed program (whether modified or not) must retain the copyright notices in the program code, but faces no other serious restrictions. As a result, anyone can modify a program subject to the BSD license and distribute the modified version as proprietary software with no obligation to make the modified source code available to other users.

OS X, the latest operating system for the Apple Macintosh, uses elements of a BSD version of the Unix operating system. The



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Apache license also allows redistribution without major restrictions on the user. These nonrestrictive licenses were relatively popular in the past, but whether they will continue to appeal to the people who start open-source projects remains to be seen.

### THE ECONOMICS OF OPEN SOURCE

To date, open source has mainly involved programmers working on projects for IT professionals and other programmers. Open-source programs aimed at sophisticated users, particularly server operating systems and server applications, have done quite well: witness Linux, Apache and Sendmail. These programs have proved popular because they meet techie needs. The fact that they are free and the user gets the source code helps, too. Open source has fallen short for average PC users, though, who demand software that is polished and easy to use. Non-techies would rather pay for something they can install right out of the box, and access to the source code does not do them much good.

The economics underlying open source sheds some light on whether this is a temporary state of affairs, as some believe, or whether open source will remain a techie-only success. I start by considering why individuals donate their time to open-source software projects and then examine the investment by for-profit companies in the development and distribution of free software.

There has been considerable debate about programmers' motives for working on open-source software projects without compensation. Josh Lerner of Harvard and Jean Tirole of the University of Toulouse have provided the most detailed analysis.

First, programmers may invest time in open source because the immediate benefits they can capture in their own work outweigh the costs. As long as they generate some net benefit for themselves, they have incentives to do the work and no particular reason not to share it with the larger community. For example, the people who initially developed Apache were system administrators who had specific problems that needed to be solved and had no proprietary alternative.

Second, programmers' success in solving a problem and making a contribution to the larger effort brings them respect among their peers. While economists tend to underestimate such intangibles, I believe this is an important form of compensation in most professions. In open source, contributions are made public through credits posted in the software code. Raymond has observed that "surreptitiously filing someone's name off a project is, in cultural context, one of the ultimate crimes." Successful contributors often obtain professionally prestigious positions in project administration.

Third, that same success may signal their abilities to the job market and help them get lucrative work. Many of the developers of Apache have been hired into proprietary software development groups.

Fourth, association with a successful open-source project may also lure investors. Marc Andreessen of Netscape attracted venture capital – and a venture capitalist in the person of James Clark – thanks to his success in developing the Mosaic browser, a project with widely available source code that in its day was the most downloaded software program on the Internet.

It is too early to tell whether investments of capital in open source will yield the same success that individual investments of time and expertise have generated. Most open-source business strategies have used open-source software to sell complementary products or services. Such businesses typically



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finance programmers who participate in open-source projects, with the rationale varying from a need to keep abreast of the technology, to solving problems that are important to their businesses, to increasing the supply of open-source software generally.

Caldera and Red Hat, for example, generate revenues by charging for bundles of open-source software that include Linux, as well as by providing user manuals and ongoing customer support. Both companies are also implementing plans to charge for updating computers with the latest Linux and related open-source code.

IBM, an enormous presence in proprietary software, has financed open-source software that it can distribute with its proprietary server hardware. IBM found Linux appealing because it sells many different types of network servers, using incompatible operating systems. Running Linux on all these servers would permit IBM to unify its server hardware lines, from small servers (basically PCs) to mainframes. IBM presumably expects to recover its investment from sales of hardware and proprietary software. So long as the open-source products the company develops primarily increase the appeal of IBM hardware rather than that of its competitors, the fact that the source code is available free to others does not create problems.

It remains to be seen how much for-profit enterprises will invest in open-source projects. All have strong incentives to ride free on the open-source development efforts of others unless they can figure out a way to capture the returns on investment through the sale of complementary products. And that requires some market power over the sales of those complementary products, so they can charge a sufficient premium to earn the investment back.

IBM may have incentives to invest in open-source projects to the extent that it makes IBM hardware more valuable to customers. But it is hard to see how Red Hat and Caldera could charge a significant premium for bundling and support services, since there are no barriers that would prevent rivals from entering these businesses and competing away profits. Some other companies with business plans based on open source have already encountered that problem. Eazel developed an open source program to manage files and hoped to make money (as do Red Hat and Caldera) from automated software downloads. It is now defunct. VA Linux Systems was a famous early company that sold server computers with Linux installed. After discovering that it could not compete with the likes of Dell and Compaq, it left the hardware business.

## OPEN-SOURCE VS. PROPRIETARY SOFTWARE

Open-source and proprietary software production methods have strengths and weaknesses that vary according to the type of software and the sophistication of the users.

The proprietary model offers two key advantages. First, the ability to capture profits by restricting access to the fruits of their labor encourages software companies to make risky investments in development. Creating a state-of-the-art computer game like Riven (the successor to Myst) can take years and cost millions of dollars. But the importance of the profit incentive goes beyond the creation of a particular software package. Most of the major software companies engage in research and development that may eventually spill over into how software is generally designed.

Second, by owning the intellectual property rights, a for-profit company can control the development and subsequent evolution of the product. While it may make mistakes in shep-



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herding the project, it has profit motives to make the program as valuable as possible to consumers. Most mass-market software vendors, for example, have chosen to make sure that their products are compatible with previous versions and to make sure that there is a "standard" current version. Having standard versions encourages the development of complements – for example, the vast array of application software for Windows.

The proprietary model has some weaknesses, though. First, to make profits, proprietary companies must limit access to the source code sufficiently to prevent copying. Most vendors of proprietary mass-market software choose not to make the source code available, even to customers. That makes it virtually impossible for customers to fix bugs they encounter or to customize software to their own needs. This, of course, is mainly an issue for proprietary software used by information technology professionals who have the ability to modify source code. It is not an issue for most consumers, who have no desire to get under the hood. But when the issue becomes sufficiently important to large customers, proprietary software companies have been known to give these customers at least limited access to their source code.

There is a second weakness. Although we generally think of free-market companies as quick to capitalize on profit opportunities, in the fast-paced world of information technology some customers may have needs that are not being met by software companies. Again, this is an issue primarily for IT professionals, and it is not clear that proprietary companies have failed to deliver the bacon very often.

The open-source method, for its part, has several important strengths. The first arises from the nature of intellectual property. Once created (obviously an important precondition), society benefits the most when intellectual property is distributed at marginal cost – which, in this case, means free. With most open-source software, no one has to pay for the software (in monetary terms at least – ease of use and lack of warranties are other matters), and everyone can use the intellectual property as they see fit.

By the same token, the fact that the source code is freely available maximizes the value of the intellectual property by making it possible for users to tailor software to their own needs. Last, by distributing the source code and providing a clearinghouse for reviewing fixes and extensions to the source code, open source provides a way for a large number of users to help with debugging and extending the software at minimal cost.

But the open-source method has disadvantages as well. First, participants in open-source projects have limited opportunities to realize a return on their time and effort. Of course, they may have nonfinancial motives (enjoyment of programming, respect of peers). But there is no particular reason to believe that they are any more powerful in software than in other products, where the proprietary model has dominated. Companies inclined to hire programmers to work on open-source software also seem to have limited profit potential, except in special circumstances. All else equal, open-source software appears likely to attract less effort – purely creative as well as nuts-and-bolts programming – than proprietary software.

There is a second disadvantage. There does not appear to be any way for the open-source method to identify and respond to the needs of nontechies. Part of the problem is that the inability to earn profits limits the opportunity to conduct serious market research. The other part is that programmers will probably invest less time working on software from



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which they gain no direct benefits.

Moreover, because open-source software tends to be written for use by IT professionals, there are few incentives to smooth out the rough edges and to make software easy to use. That limits the prospects for open source in the software used by the vast majority of consumers. In 1999, it's worth noting, software not used by IT professionals generated a little less than half of all revenues from packaged software sales.

## THE FUTURE OF OPEN SOURCE

Although experience suggests that surprises are possible, open source does not seem a viable model for producing mass-market software. To see the difficulties, consider Linux. In many ways Linux seems well positioned to become an operating system for "client" computers – the hundreds of millions of desktop and laptop machines at the end of networks. It is used by IT professionals on millions of network servers and has a number of good computing properties – for example, a disinclination to crash. But it has made only limited progress in evolving toward an operating system that companies could ask their employees to use or that home users would want to use.

Linux doesn't have a standard easy-to-use graphical interface. And it can't boast of many high-quality, user-friendly applications that appeal to mass-market users. It also offers fewer hooks for application software developers to use in developing complementary programs with a consistent look and feel.

No doubt, Linux will overcome some of these weaknesses. Nevertheless, it is hard to imagine what financial or nonfinancial incentives would make programmers spend time working on products like spreadsheets or statistical software that they do not use, or why they would be particularly good at creating high-quality software in areas far from their interests or expertise.

Open source is more promising for software written by techies for techies. However, several factors may retard the spread of open source. Many software products – and especially operating systems – have become popular because so many other software products work with them. The Free Software Foundation's GPL, however, makes it difficult for proprietary companies to produce software that complements open-source efforts because it is too easy for the proprietary code to catch the GPL licensing virus.

Another problem is that producers of complementary software and hardware tend to exchange technical information during development cycles. The decentralized evolutionary model used in open source makes such coordination much more difficult.

The thousands of programmers around the world who volunteer their time for open-source projects provide the movement's greatest strengths. But one wonders how much effort these volunteers will offer to projects that are important to the future success of open-source software but that are neither intellectually challenging nor of immediate utility to themselves.

Likewise, open source could become a victim of its own success. As it evolves from a hacker phenomenon to an industry backbone with formal institutions, it is easy to imagine that those who offer assistance because they like being part of a cool club will find it less alluring – sort of like the difference between hanging out at a funky cafe and at one of the six Starbucks on a block. And if companies really do start making significant profits by producing services that feed off the open-source movement, one can also imagine that unpaid volunteers will lose their enthusiasm for helping. M



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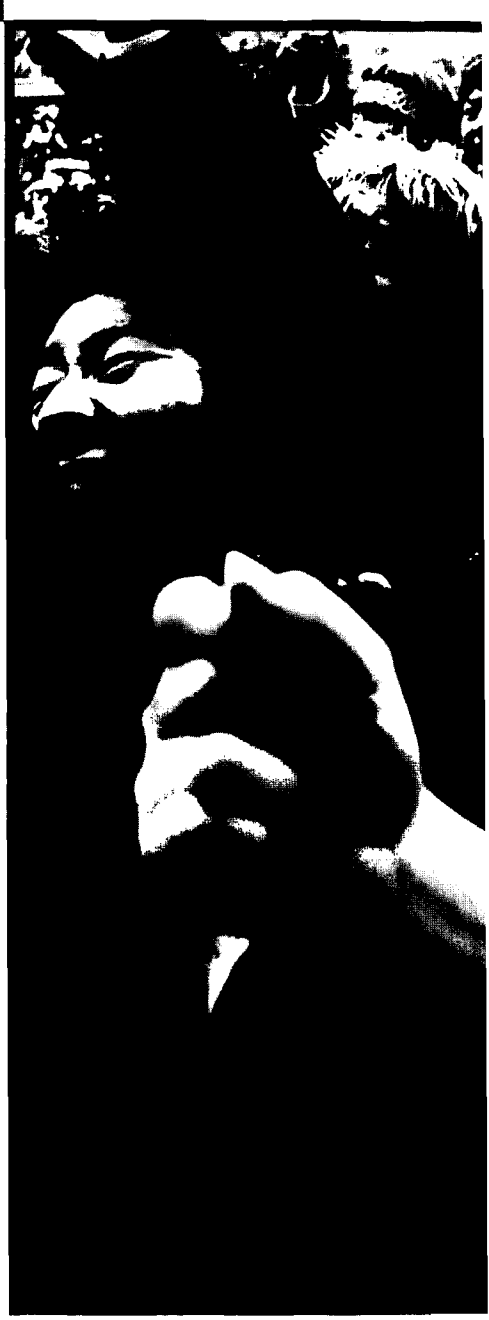
# Japan on the Cusp



*By Victoria Marklew*

Japan has a new prime minister with a signature haircut, a penchant for self-promotion, and plenty of catch phrases about reform and restructuring. Junichiro Koizumi's ideas, and the adulation he has enjoyed in his first months of office, have generated vigorous debate among long-time Japan watchers. For over a decade most of us have been (accurately) predicting business-as-usual in Japan – sub-par economic performance complemented by painfully slow legislative response and bitter resistance to letting the sun shine on the financial sector's famously opaque accounts. Now, even the most cynical Japan-watchers have been caught up in the excitement. Is Japan headed for a new era of growth – or for a crash-and-burn depression? Will the interest group gridlock preventing financial reform finally be broken? Or is Japan destined for more of same – a minuet of half measures and government forecasts of prosperity just around the corner?

Start with some basics. On the plus side, Japan is the world's largest creditor. The yen is the world's third most widely traded currency (behind the dollar and the euro). And



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its diverse, productive economy can still boast of a potent manufacturing sector that consistently produces an export surplus. On the other hand, the Japanese economy has



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all but ceased to grow. In spite of the stimulus from 13 massive government spending/recovery packages in the past decade, the growth rate averaged a meager 1.1 percent. And now, the economy is drifting back into recession – its fourth in ten years.

This latest slump reflects something more ominous than the global slowdown. Industrial output is falling, inventories are rising and exports are contracting, while unemployment has hit post-war highs and consumer confidence is very weak. As of this writing (mid-September) stock prices were at 17-year lows. Most worrying, however, is that deflation has become entrenched. The "core" consumer price index – one with the most volatile components removed – has been falling since October 1999. And all those ineffective fiscal stimulus packages over the past decade have left Japan with a public sector debt equivalent to $5.5 trillion. With the budget deficit running at an incredible 7-10 percent of GDP this year, the government has no more room for fiscal expansion.

That's only part of the bad news. Japan's banks are crippled by mountains of bad debt (non-performing loans, or NPLs in financial-speak), and bank lending has fallen for 42 straight months. The government has already spent some ¥18 trillion ($150 billion at current exchange rates) in public money to prop up the banks over the past few years. Even so, the current administration, the Bank of Japan, the IMF and many others point to those NPLs as the primary obstacle to an enduring economic recovery.

VICTORIA MARKLEW is the senior international economist for the Northern Trust Company of Chicago

### A CLOSER LOOK AT THE BANK MESS

The opacity of the banks' financial statements has tormented Japan-watchers for years, and each of us has his/her own guesstimate of the magnitude of the bad debt problem. Back in April, Japan's Financial Services Agency (FSA, the banking regulator formed three years ago) said that the nominal value of "troubled" loans held by the nation's banks and credit unions stood at about ¥150 trillion, implying that NPLs could represent as much as 22 percent of all outstanding loans.

**The pace of asset quality deterioration in the current recession is probably more important than pinpointing the true magnitude of dud loans.**

Earlier, the FSA had put the number at ¥80 trillion, which turns out to have been the official total excluding loans backed by what the FSA calls "sound" collateral. However, little of this collateral is really sound. Much of it is backed by credit-guarantee firms that are themselves subsidiaries of the banks, or is guaranteed by corporations whose own financial health is in doubt. And a good chunk of the collateral is in the form of land – golf courses, cemeteries and the like that are at best illiquid and more likely worth a lot less than the owners claim. The FSA says that ¥117 trillion of the banks' "troubled" loans are still paying interest and therefore do not count as non-performing. However, we can assume that the ongoing economic slowdown



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will tip many of these into the NPL gutter, and that the banks' provisioning for these loans is inadequate.

In fact, in assaying the health of Japan's banks, the pace of asset quality deterioration in the current recession is probably more

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important than pinpointing the true magnitude of dud loans. If we assume a downside risk on all problem loans and on all loans supported by collateral, then the major banks likely have reserve shortages that could wipe out their operating profits for at least the next couple of years. However you do the math, the banks are in trouble.

Added to all this, the major banks appear to have been active players in the murky financial derivatives markets over the past couple of years, with as much as ¥40 trillion in interest rate "swaps" on their books – but off their balance sheets. It's not clear whether the banks have been trying to lock in margins, or actually speculating in a bid to boost their operating income. If it's the latter, a rise in long-term interest rates could quickly wipe out a hefty chunk of some banks' capital – assuming they have any left to lose.

The state of the banks' balance sheets goes a long way to explaining why lending has been in a prolonged slump. It doesn't entirely explain, however, why all those fiscal stimulus packages failed to yield what became the mantra of successive governments: a "self-sustaining recovery." Some claim their failure proves that counter-cyclical fiscal spending is



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a fool's errand. It's more accurate to say that the past decade's stimulus attempts in Japan have failed because of deep, structural rigidities within the Japanese financial system.

To put it in somewhat different terms, the economy has never recovered from the collapse of securities and land prices a decade ago because interest-group politics has closed every avenue to effective change. This explains why Koizumi's calls for reform are striking such a resonant chord, and why his proposals could have a major impact on the way the Japanese economy functions.

### JAPAN'S SAVINGS

One of the notable oddities about Japan's economy is the very high national savings rate. Indeed, one school of thought points to this "structural savings surplus" as the root of all the economy's woes. According to the IMF Japan's private savings averaged 27 percent of GDP in 1995-2000, compared with 21 percent in Europe and about 15 percent in the U.S. Now that Japan's living standards have caught up with those in the industrialized West, it appears that there is nowhere productive for this money to go. When all these savings poured into the bubble economy in the late 1980s, it simply boosted land and stock prices to Alice-in-Wonderland levels instead of generating productive capacity.

In fact, many argue that the only productive way to employ the surplus savings of this rich and rapidly aging society is to invest it abroad. Martin Wolf of the *Financial Times* says that efforts to make the Japanese absorb their savings at home (and thereby run smaller trade surpluses) have been "a catastrophic blunder." From this perspective, government reforms that reduced incentives to throw money down domestic rat holes would make the problem of excess savings even worse.

But this begs the real question: why is there this stagnant pool of savings in the first place? For one big part of the answer, look to Japan's Postal Savings System.

The PSS dominates the domestic financial market. It absorbs at least a third of all household deposits; with some $2.2 trillion on board, it is the world's largest bank by far. The PSS also sells about a third of Japan's life insurance. The post office, which runs the system, has some 25,000 branches – one for every 5,000 people.

Japanese citizens aren't about to stop saving, and the PSS makes it hard for them to look for other outlets. The local postmaster is a major financial advisor in the community. Indeed, there are no alternate sources in many places – no 401(k) providers or mutual funds angling for small accounts. Koizumi's talk of privatizing the PSS suggests that he understands the problem. But horror in disturbing this symbol of financial rectitude would make privatization a daunting political task.

Until earlier this year, Postal Savings funds were automatically transferred to the Ministry of Finance's Trust Fund Bureau, to be invested in the government's Fiscal Investment and Loan Program (FILP), whose budget equals about 10 percent of GDP. The cash helps to support some 77 public sector financial institutions that control about half of the capital flows within Japan. These institutions include the Housing Loan Corporation (which provides about two-thirds of all residential mortgages), the Highway Corporation, the Japanese Development Bank and a host of other monuments to the pork barrel.

These public corporations' annual budgets are reputed to be nearly half the size of the official government budget. And some are thought to be sitting on large, hidden losses. Back in early 1997, the government planned to consolidate, abolish or privatize some of



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these corporations, but only skimmed the surface – probably because they were too tied into the political system to be pushed around, and maybe also because the finances of many were deemed too expensive to fix.

Still, change is coming. As of this year, FILP-financed entities must raise their own funds. This means that the PSS is starting to act more like a stand-alone government bank, which should make the system more transparent and more sensitive to market incentives. Furthermore, the post office is slated to be converted to a public corporation in 2003, and Koizumi has said that he will then push for true privatization. Such a step would radically reduce state-directed financing in Japan.

Which takes us to the political side. The Liberal Democratic Party has utterly dominated Japan's politics since the 1950s. And the FILP and the public sector corporations have long been used as an instrument to maintain the party's standing. Local government financing and many private industries depend on FILP funds. The construction industry, rural areas and small businesses – all major LDP supporters – have benefited from government financed building programs, road projects and special lending programs.

When Japan's land and stock markets collapsed a decade ago, there was nowhere else for individuals' savings to go but back to the government bond market, via the PSS. These bonds were used to fund public works projects through the big stimulus packages that have given the economy some short-term aid but no enduring boost. The 1990s became the decade of over-investment in unproductive public assets like roads and bridges to nowhere – projects that supported no one but the construction industry and rural retailers who (surprise, surprise) pay the bills and generate votes for the LDP.

**The economy has never recovered from the collapse of securities and land prices a decade ago because interest-group politics has closed every avenue to effective change.**

### REFORM IS THE ANSWER – BUT WHAT IS THE QUESTION?

By this view of what went wrong, the current government's reform agenda would seem the right prescription to re-energize the economy. Koizumi portrays himself as a maverick who eschews the LDP's factional politicking, and who speaks openly of the need for painful structural change. Along with his Minister for Economic and Fiscal Policy, Heizo Takenaka, and the head of the Financial Services Agency, Hakuo Yanagisawa, he has sketched out a plan: tackle the banks' NPLs, think about restructuring and privatizing some of the public financial institutions and ultimately the post office, accelerate deregulation seen in recent years, and start restructuring public finances by putting a cap on spending.

Meanwhile, METI (the Ministry of Economy, Trade and Industry) is now pushing the alternative view that the essential cause of Japan's economic stagnation is its declining ability to innovate. The ministry said recently



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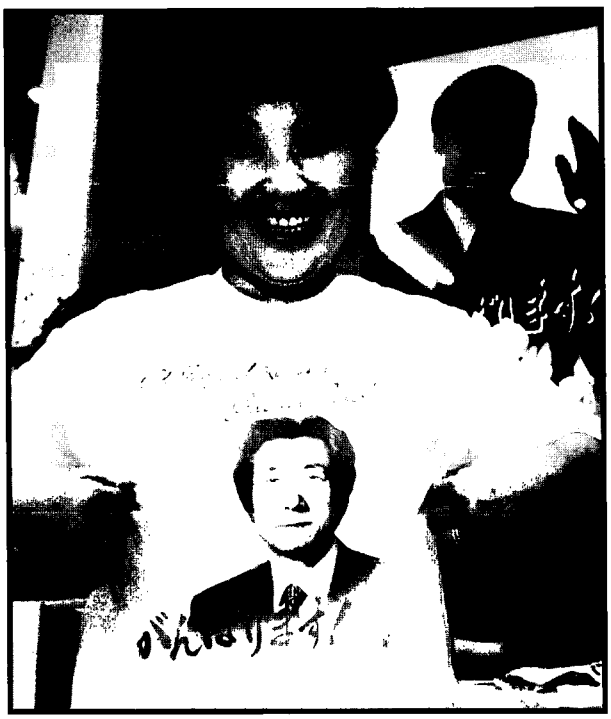
that Japan "needs to develop a market environment and to initiate immediate structural reform," and called for genuine competition. This was a startling comment to come from the former bastion of state-directed economic planning and trade protectionism.



Clearly change is afoot in Japan, and we are seeing some potentially radical shifts in attitudes and policy prescriptions. But will this be yet another false dawn? Alan Greenspan, the International Monetary Fund and the Japanese government itself say the first priority must be the write-off of the banking sector's NPLs; until the banks take the hit, nothing else can happen. Others say, to varying degrees, that whatever happens with the banking sector, the effect of the structural reforms proposed by Koizumi will be disastrous because of the nation's high savings rate, which reflects insufficient domestic demand. Some Cassandras are pointing to the parallels with the United States in 1930, when the consensus in the aftermath of the stock market crash favored liquidation – "pain and purge" – along with tight money to enforce discipline. And we all know how well that turned out.

## DEFLATION AND DEMAND

The Cassandras have a point. It is not the high national savings rate per se that could doom Koizumi's reform efforts, but rather the deflationary spiral that now grips the economy. One could get into a real chicken-and-egg quandary here – is the high savings rate exacerbating the disinflation seen in recent years? Or, has a tendency to deflation created an even greater savings surplus? Either way, deflation is now entrenched, and the prime minister's reform plans are likely to lead to even sharper price falls and still weaker demand – and at a time when international trade has contracted.

The Bank of Japan (BoJ) occasionally claims that falling prices are a positive sign of reform, as deregulation leads to improved price competition among producers. There is also downward pressure on prices thanks to cheap imports, an increasing proportion of them re-exports by Japanese companies that are outsourcing both agricultural and manufacturing production in the likes of China.

But on top of this there's that high national savings rate, which is not going away. With about 25 percent of the population expected to be over the age of 65 by 2015, Japanese have good reason to be socking away cash. Elderly savers have long been in the habit of putting a bit away in the post office every week, and talk of rising debts and the need for fiscal reform must add to their fears of both

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future cuts in retirement programs and higher taxes. In addition, everyone was hit by the destruction of wealth when the real estate and equity bubbles burst, and everyone is aware that the financial sector has problems. Now, add deflation, which generates its own vicious cycle to the mix of incentives: cash is worth more tomorrow than today – another reason to save – which in turn leads to less consumer spending and lower aggregate demand, and so more falling prices.

## JAPANESE MONETARY POLICY

In the face of a looming deflationary spiral, the BoJ has actually shifted its policy stance in a fairly radical way. Back on March 19, the central bank stopped focusing on interest rates and instead announced it would pursue a quantitative monetary policy. That is, instead of stipulating the rate at which it will lend money to the banking system, the BoJ is now targeting its own account balances at private financial institutions. As a first easing step, the bank boosted that balance from around ¥4 trillion to around ¥5 trillion (which had the effect of reducing the overnight loan rate to zero), and has since pushed it up to ¥6 trillion.

The Bank blamed the U.S.-led economic slowdown for its change in stance, and promised to maintain this easing policy until consumer prices stop falling. In mid-August, the BoJ increased its purchases of Japanese government bonds (JGBs) from a monthly level of ¥400 billion to ¥600 billion, adding to the money supply by trading cash for securities. Some things don't change, though; each time it takes a step, the central bank says it has now done all it can, and Governor Hayami makes repeated reference to the need for structural reform in the financial system.

The standard measure of Japanese money supply has started to edge upward, and the monetary base is clearly expanding, up an impressive 9 percent on the year in August. But it appears that the bank's actions have been too little, too late. Prices are still falling and private lending continues to contract. It seems that liquidity is rising but the money is not going anywhere productive. Given the abysmal state of the banking sector and Japan's ossified system for allocating savings into capital, the BoJ's responses amount to no more than "pushing on a string."

For a financial system stunted by decades of concealment and pork-barrel economics, Koizumi's reforms imply a fundamental reorientation in the way that Japan's political-economic system has functioned since the post-World War II occupation. Attempting this when the banks' financial health is compromised and the global economy is sputtering is perilous, indeed.

## HOW TO CREATE INFLATION

There is a fundamental mismatch between Koizumi's reform ideas and the current deflationary environment – the reforms would exacerbate deflation and deflation could prevent the reforms from functioning. This makes it imperative that the BoJ take aggressive steps to reflate the economy. If we look not at nominal interest rates, but at real interest rates (the nominal rate minus the rate of deflation), it is clear that in 2001, with prices still falling, the equity market on the skids and investment spending down, real interest rates are still too high.

The problem is that central banks, like armies, tend to refight the last war. The BoJ has been spooked by the fact that when it allowed a sudden and marked increase in monetary base growth in the late 1980s – reaching an annual rate around 12% in 1989 – it fed the stock market bubble. The central bank has also repeatedly warned that it doesn't



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want to encourage profligate politicians. And given their history of pork-barrel practices, who can blame it?

The BoJ does seem to be experiencing a change of heart, shifting to the policy of quantitative easing, exploring technical means for making monetary intervention more efficient and transparent, and increasing purchases of long-term bonds. But this may not be happening fast enough to stop the deflation juggernaut. The bank should probably also set an inflation target in order to change expectations; at this stage, psychology must be a part of the game plan.

There's also the lower yen scenario, which the government began subtly propounding in early August with hints that additional monetary easing would mean a weaker yen and that the currency should in any case reflect "economic fundamentals." A weaker yen would benefit the nation's beleaguered exporters and could help to shift expectations about prices. Unfortunately for Japan, the currency was moving in the opposite direction through the third quarter. But let's not forget those financial derivatives that may be lurking on the large banks' books. A yen fall could lead to higher nominal long-term interest rates and falling bond prices, forcing the banks to renegotiate their swaps or to put up more cash – further damaging both their capital and their credibility.

### REFORM PLUS...

The combination of bankrupt banks, deflation, reform and a global slowdown could send the world's second-largest economy crashing into a full-scale depression, with dire consequences. So is there any hope?

Yes – if the BoJ adopts a more aggressive stance toward deflation, and the government adopts a more aggressive stance toward banking sector reform. And while the government has yet to acknowledge the need, this must include using public funds to recapitalize the banks – which in some cases would mean nationalization and closure.

After years of rolling over bad loans rather than forcing the bankruptcy of politically connected borrowers, the banks' balance sheets are a mess and they no longer have the capital to clean them up on their own. Even the chair of the Keidanren, Japan's powerful business federation, said in June that the government may need to nationalize a few large banks to allay market unease. However, using public funds to consolidate the banks would require a unified government willing to spend more on the banks when unemployment is rising sharply and the government budget is already deep in hock.

### THE NEED FOR POLITICAL CHANGE

To achieve a revolution in Japan's financial sector, there will need to be one in the political sector as well. The LDP and the postal savings system have been scratching each other's backs for decades, and the resistance to a new regime is likely to be fierce.

However, the ability of the old guard to sustain business as usual appears to be slipping, and there could be a mass voter repudiation of the old ways in the not-too-distant future – that is, unless the economy crashes first. For now, consider the way that Koizumi was chosen to head the LDP, and hence to become prime minister. On April 24, the LDP's 346 members of parliament each cast a vote for the next party president – which in previous years had meant the various faction members dutifully supporting the choices already made by their leaders. However, this time around, the LDP's 47 regional chapters with a total 2.3 million rank-and-file party members, were give a chance to vote before



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the parliamentary ballot.

The result was a resounding grassroots call for change, with 123 of the 141 chapter votes (each regional chapter had three votes) going to the outsider, Koizumi. With the popular momentum clearly in his favor, Koizumi won 175 of the parliamentary votes, giving him a total of 298 out of the 487 votes at stake. Former Prime Minister Ryutaro Hashimoto, the favorite of the back-room gangs, won just 155 votes altogether, and only 18 of them from the party grassroots.

**There could be a mass voter repudiation of the old ways in the not-too-distant future – unless the economy crashes first.**

In the June 24 election for the Tokyo legislature and the more crucial July 29 vote for one half of the seats in the national House of Councilors, the LDP captured more seats thanks to the Koizumi phenomenon. Just months earlier the party elders had feared a rout. Yet the LDP is still short of a majority in the House of Councilors, making it necessary to maintain a coalition with its two allies, the New Komeito and New Conservative parties. Neither favors reform, however, and loss of their support would trigger an early election since the government wouldn't be able to push legislation through the upper house.

The LDP encompasses a range of views that in other democracies would be found in a spectrum of parties – everything from reformists, who espouse New Democrat/New Labor-type policies, to unreconstructed right-wingers, who believe Japan's military past has been unfairly criticized. And although the party's base is wide, including farmers and rural residents, small retailers, the elderly, postal workers and the construction industry, it is becoming shallow thanks to the modest reforms already undertaken and to the decline of the old industries.

Serious reform would further erode this political base. Pushing bad debt write-offs by the banks would mean bankruptcies and job losses, and would hit the bloated construction industry particularly hard. Deregulation of textiles and agriculture would lead to an upsurge in cheaper imports that might delight consumers, but would certainly decimate many producers. And, unless the BoJ acts more aggressively, the economy could fall into an outright depression.

In winning the leadership of the LDP, Koizumi emphasized that Japan will see no long-term gain without some short-term pain. But voters don't fully realize what that means. Initially, Koizumi spent his time building his popularity to near rock-star levels, managing to ensure his hold on power for at least a couple more years. Now he must build on that support to drag the LDP into a new era. If the old guard dig in their heels, he has threatened to call a snap general election. Perhaps Koizumi and other reformers will even try to create a new party from like-minded members of the opposition and the wreckage of the LDP.

There is no precedent in Japanese history of an outsider controlling the national political agenda effectively enough to win voter tolerance for radical change. The question now is whether the reformers manage the process well enough to make it work. M



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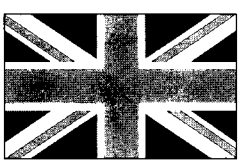
# The House that Jack Built

## The story of British welfare reform

*By Robert Walker and Michael Wiseman*



Last year's American presidential election was unusual in several respects. One surprise – possibly not the first to come to mind – was the virtual absence of debate over welfare reform. This novelty was inevitably short-lived, though, since funding for two of the pillars of American social-welfare policy, the Temporary Assistance for Needy Families program and the food stamps program, is scheduled to expire before the 2002 Congressional elections. By last spring, the debate was reviving old controversies and engendering new ones about the appropriate direction for the nation's welfare system.

Like virtually every other aspect of American social policy, this debate has been put on hold by the events of Sept. 11. But it will not go away. Indeed, a recession exacerbated by terrorism could provide the first major test of the new safety net created in 1996 by the Personal Responsibility and Work Opportunity Reconciliation Act, the legislation that replaced welfare as we knew it.

The states led the original debate over welfare reform with their own initiatives, and state policy since the enactment of the 1996 legislation remains a major focus of the debate. During the first week of September, the Department of Health and Human Services brought several hundred state practitioners and program administrators to Washington for a conference, *Five Years Into Welfare Reform: Lessons*

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*Learned and Models for the Future*, that was billed as an "opportunity to exchange information on experiences, learn of promising program strategies and consider what can be done to carry out the next phase of welfare reform."

Notably absent from the event was an indication of the Bush administration's own vision for welfare reform, save the pablum of providing for the "many families who need help in finding and succeeding at work" and the promotion of "strong and stable families and healthy marriages." Tommy Thompson, the secretary of Health and Human Services, who led the welfare reform effort in Wisconsin as governor, was forced to cancel his own appearance to testify on stem-cell research before a congressional committee.

*Five Years Into Welfare Reform*, it's worth noting, included no representatives from outside the U.S. and made no reference to experiences elsewhere. This parochialism is unfortunate. While welfare reform in America has attracted a great deal of international attention, the U.S. has no monopoly on social-assistance innovation. And contrary to the common presumption, policy elsewhere – notably Britain – may be highly relevant here.

Britain and the United States are within hailing distance at many levels of exchange on welfare policy, from the art of political rhetoric to the particulars of administration. This proximity reflects longstanding similarities as well as current trade in ideas. And the active borrowing of American ideas by British policymakers has reduced the distance even further, making Britain's social policy terrain even more accessible to Yanks than a decade ago. But distance may be less important than accomplishment; welfare reform in Britain has moved beyond U.S. achievements. Like the experience of the states, British strategy is thus worthy of attention when the reauthorization debate resumes.

**ROBERT WALKER** is professor of social policy at the University of Nottingham and fellow at the Institute for Fiscal Studies. **MICHAEL WISEMAN** is research professor of public policy and economics at George Washington University.

## SETTING THE STAGE

Before looking for lessons in Britain, consider some key differences between the two countries.

Begin with size and wealth. Britain is smaller than the United States (60 million versus 273 million people) and less well off. Britain's 1999 per capita gross domestic product was $23,900 at current exchange rates, compared to $33,900 in the United States. This difference is arguably less important for social policy than the fact that Britain is a highly centralized, unitary state. Almost all social policies are national in coverage, and job-placement services, social assistance and social security benefits are largely delivered by national agencies. Local governments do provide social work and educational services, but such provision is tightly regulated from the center.

Moreover, the parliamentary and electoral systems give British governments virtually unfettered power to introduce and implement policies without need for compromise.

Britain conducts its welfare-to-work programs in the context of a social insurance system that includes two important universal benefits absent in the U.S. The country's health service is national and largely free, so ready access to health care need not be linked to welfare receipt or eligibility. Then, too, the provision of a universal child benefit in Britain without means-testing lessens the risk of poverty and reduces the financial disincentives that large families experience in the



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United States for moving from welfare to self-support.

Beyond these common benefits of citizenship, means-tested social assistance is universally available in Britain. A single-parent family (more accurately termed a lone-parent family) with two children now receives a basic benefit of about £526 per month, in addition to rent. On average, the housing benefit adds £258 per month, for a total income of roughly $1,200 at current exchange rates.

This exceeds the maximum combined temporary assistance and food stamps benefits in any state, and is comparable to the most generous state benefits for households that also receive rent assistance. However, the important difference lies not in the disparity in amounts but in the absence of categorization. In the United States, temporary assistance is available only to families with children. Adults without children must rely on other programs, and in most localities, cash support for the non-elderly childless poor is simply not available.

In Britain, by contrast, almost everyone who is not working 16 or more hours per week and lacks income is eligible for assistance. Retirement pensioners constitute the largest group of social assistance recipients in Britain, followed by disabled people. Unemployed claimants have, until very recently, outnumbered lone parents.

Britain also has proportionately more public housing than the U.S. Even after two decades of privatization, public units still account for 22 percent of the housing stock. Another 4 percent of dwellings are offered by social housing organizations. The housing benefit cited earlier is available to meet some or all of the rent of almost anyone with income below a threshold level, irrespective of employment status. There are even universal means-tested rebates for local property taxes.

A final difference to note is that, although disproportionate numbers of unemployed and lone-parent claimants in Britain are from ethnic minorities, race is almost entirely absent from British debates on welfare. Ethnic minorities account for less than 7 percent of the United Kingdom's population.

CHRIS STEELE-PERKINS/MAGNUM PHOTOS

Americans typically find the scale, comprehensiveness and coverage of British social assistance remarkable. Cash benefits are generally not restricted to particular groups in the way that the Temporary Assistance for Needy Families program is primarily designed for single parents. This difference is the product of history; British social assistance evolved as a response to mass unemployment rather than to the needs of dependent children in one-parent households.



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## BRITISH WELFARE REFORM

Labor exchanges and unemployment insurance were introduced in 1909 and 1911 respectively; the exchanges came first to ensure that job-search obligations could be adequately policed. Mass unemployment in the aftermath of World War I led to a temporary form of unemployment assistance – the dole – for those workers who had exhausted entitlement to insurance benefits.

This combination of unemployment insurance and means-tested residual benefit largely remains in place – although the details were modified at the end of World War II and subsequently. Indeed, it was the fear that the United States might follow a similar trajectory that led FDR-era policymakers to keep the unemployment insurance system separate from relief.

Britain's Beveridge reforms after World War II extended unemployment insurance to most full-time workers and consolidated social assistance into a single system covering all poor adults. The labor exchanges retained responsibility for payment of unemployment insurance, but did so on behalf of a new Ministry of National Insurance.

The Beveridge report recommended fixing benefits at subsistence rather than on the basis of prior earnings. The consequences of this seemingly modest policy choice were profound, for in so doing Beveridge ensured that Britain would rely on means-testing and not follow the non-means-tested route taken by social democracies in continental Europe. In consequence, the debate about welfare reform in Britain is commonly couched in terms of means-tested benefits, as it is in the United States, although the beneficiaries include a much broader range of citizens.

As in the U.S. before the advent of the Work Incentive Program in 1967, British employment and social assistance policy developed along separate tracks for much of the post-World War II era. In 1974, administration was split from job placement – a change that underscored the passive-entitlement nature of the benefits system. Until well into the 1980s, British policy was to tackle mass unemployment by limiting labor supply, diverting older workers into retirement and young people into training and work-experience programs.

Thereafter, a Thatcher government in awe of American economic achievements shifted the emphasis toward deregulation and labor market flexibility. Direct taxation was reduced, while means-tested wage subsidies were extended and increased. The out-of-work benefit level was pegged to enhance work incentives, and job-search obligations were rigorously enforced. The 1986 introduction of a mandatory program of regular interviews for unemployed claimants was credited with sharply increasing the annual outflow from unemployment.

The pace of policy development quickened in the 1990s and broadened as concern about benefit dependency (a termed first used by government ministers in 1987) and the possible growth of an underclass increased. The role of American conservatives in feeding these concerns is well documented. The ideas of Charles Murray and Lawrence Mead were particularly influential, disseminated through influential right-of-center think tanks in Britain, like the Institute of Economic Affairs and the Adam Smith Institute. Meanwhile, a U.S.-inspired jobs study published by the Organisation for Economic Co-operation and Development (OECD) in 1994 broadened political support for tackling poverty by employment-led reforms.

In 1996, job-placement and benefit payment were reunited by the Conservative government in a program that made benefits



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conditional on signing a contract specifying the steps that claimants are expected to take to find work. It also combined unemployment insurance and assistance benefits into a single plan. In the same year, the first British workfare scheme was created for young workers who had been unemployed for two years. Fear that disability insurance claims were masking unemployment and dependency led to tightened eligibility requirements and a review of all existing cases in 1997.

The reappraisal of the policy toward lone parents occurred a little earlier than that relating to the disabled. Once again, the debate resonated with American ideas. Prior to the mid-1980s, nonworking lone parents were entitled to receive cash assistance, and when the program was remodeled in 1980 and 1987, lone parents received extra benefits. Also, from 1977 to 1999, a small non-means-tested addition to child benefits was made available to lone parents who worked.

However, a 50 percent increase in the number of lone parents, a 9 point fall in the percentage who worked, and high levels of nonpayment of child support by absent parents changed the policy debate by the early 1990s. The tenor became shrill with Charles Murray's predictions of a growing British underclass fed by the feral offspring of lone mothers resonating with Mrs. Thatcher's moral indignation and fervent espousal of traditional family values.

Following reviews of American and Australian child-support policy, a new system of support collection from absent parents was



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established in 1993. Collections were initially restricted to absent parents of children receiving social assistance. Establishing an agency to collect these payments was arguably the most ambitious piece of social engineering since the first flurry of reforms after World War II. But the new policy faced vocal opposition from many quarters, and its implementation was chaotic.

Financial incentives were also introduced to encourage lone parents to take jobs. Until 1999, benefits for households with earnings mostly came through programs that included a substantial marginal disregard of earnings, which acted essentially as a wage subsidy. Eligibility depended on the hours worked. Originally the threshold was 30 hours; this was reduced to 24 hours in 1988 and then to 16 hours in 1992. In addition, the government introduced a partial disregard of child support (maintenance) received from absent parents in the calculation of benefits.

The proportion of lone parents employed increased from 39 percent to 44 percent between 1993 and 1998. However, there was little support for making work compulsory. The public seemed to accept the profound changes in gender and sexual relations, the availability of divorce, and the rise in cohabitation that contributed to the growth in lone parenthood, and was divided about the wisdom of creating latchkey children by imposing work requirements.

In sum, despite important differences, similarities between the U.S. and Britain in the patterns of welfare provision were already well established before the Labor government was elected in 1997. The two nations shared an emphasis on sustaining a deregulated economy and labor market, a view that welfare should be means-tested, an agreement that employment was the best route out of poverty, and an emphasis on personal responsibility.

These similarities did not arise by accident or as an independent response to common problems. Rather, there was a substantial importing of both ideas and strategy, with Britain adapting and naturalizing policies originating in the United States.

## NEW LABOR'S TURN

The reforms of the 1997 Labor government constitute an extension of – not a break with – the policy developments of the previous 15 years. Moreover, the influence of American thinking at all levels, from rhetoric to implementation, has been even more marked. The unique contribution of the Labor government has been to elucidate the objectives of welfare policy and to present them in positive, unifying terms rather than in negative, polarizing ones. Welfare reform is recognized as just one element in a coordinated response to social and economic change. Reform is part of modernizing government and the labor market to equip individuals and society to succeed in an increasingly open economy.

New Labor's approach is well illustrated with reference to four packages of policies that have grabbed the headlines. The first two, "welfare to work" and "making work pay," sound familiar to American ears. The second pair, "tackling social exclusion" and "ending child poverty," much less so.

The year 1997 was the first in almost a half-century in which a British government was elected on a manifesto promoting welfare reform (echoing the Clinton election promise to "end welfare as we know it"). The centerpiece of the Labor government's welfare-to-work agenda was a commitment to return 250,000 young people to work within the tenure of the first Parliament. The influence of American thinking is clearly evident in the



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structure of the flagship program, New Deal for Young People, which is aimed at twenty-somethings. It comprises a period of active job search followed by a suite of options, graded according to distance from labor market, and a follow-through for those people who have failed to get jobs.

The options – subsidized work, education and training, voluntary and environmental work or self-employment – bear a striking resemblance to those offered under Governor Thompson's Wisconsin Works (W-2) scheme. It is no coincidence that British ministers, civil servants and members of Parliament all visited that state in 1997 or 1998. For New Deal for Young People is a clear adaptation of a U.S. policy – albeit one that changed the target group and incorporated the objective of raising skill levels.

Ironically, given that young people are largely excluded from the U.S. welfare system, even this focus on youth can be traced to U.S. influences. Government policy papers reference American research documenting the link between youth unemployment and crime. And in his first set-piece speech after assuming power, Prime Minister Tony Blair spoke the language of the underclass debate:

> For a generation of young men, little has come to replace the third of all manufacturing jobs that have been lost. For part of a generation of young women, early pregnancies and the absence of a reliable father almost guarantee a life of poverty.

The difference was that Britain mandated employment for men before mandating it for lone mothers. Moreover, while compulsory involvement was extended rapidly, the next targets were, again, not lone parents but the long-term unemployed and, later, the partners of the unemployed. Involvement of lone parents and disabled people was initially voluntary, with an emphasis on work-oriented advice rather than work experience. This reflects the more inclusive nature of British social policy.

**Welfare reform is recognized to be less important in itself than as one element in a coordinated response to social and economic change.**

But as the family of New Deal programs has expanded (there is now even one for musicians) the core combination of intervention organized around a staged approach to movement from welfare to work and for organizing service delivery is present virtually everywhere. Programs have become more differentiated as emphasis on flexible response has grown.

The "making work pay" agenda was also generalized in its target. But again, it was influenced by American thinking. Key elements included the introduction of a minimum wage set at a level informed by the U.S. experience, and the adoption of wage subsidies delivered through the tax system that were available to all low-income families with a member working for more than 16 hours each week. The design of this tax credit is a hybrid. Like the benefit that it replaced, it is paid every two weeks and includes an option for routing cash directly to the principal caretaker for the wage earners' children. But like the earned-income credit in the United



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States, it is calculated in conjunction with wages and is the province of the tax system rather than the benefits agency.

Labor's commitment to tackle social exclusion reflects European influences on British policy. However, Labor has used the phrase as shorthand for multiple deprivations, with an emphasis on the processes that generate hard-

DONAVAN WYLIE/MAGNUM PHOTOS

ship. In so doing, Labor has sought to shift action and expenditure away from solving short-term problems and toward preventing future ones.

The government identified a number of facets to the problem: lack of opportunities to work and to acquire education and skills, childhood abuse, disrupted families, barriers to older people living fulfilling and healthy lives, inequalities in health, poor housing, poor neighborhoods and crime. It also recognized that many of those living in poverty had not benefited from economic growth.

Labor's approach to date has followed three tracks. First, project teams address specific forms of social exclusion: homelessness, truancy and exclusions from school, teenage pregnancy and neighborhood decay. Second, regional strategies focus resources on local communities, seeking to coordinate agencies and to engage the local populace in the process. The names given these initiatives – Sure Start (loosely modeled on the American Head Start), Health Action Zones, Employment Zones, New Deal for Communities, Education Zones, Single Regeneration Budget – signal different policy emphases within a common approach.

The explicit commitment to eradicate child poverty did not emerge until February 1999, although it was foreshadowed by the liberalization of benefits programs aimed at children. Prime Minister Blair linked the commitment to his aim of making welfare popular. Equally, though, it was a response to growing child poverty (a phenomenon that until recently Britain has almost uniquely shared with the United States among advanced members of OECD countries, and new evidence that childhood deprivation is directly linked to life outcomes).

While President Clinton referred to ending child poverty as a "pledge to 21st century America," Blair set a date: end child poverty in 20 years. Subsequent government publications have refined this pledge to include intermediate objectives. The bedrock of the strategy relies on the welfare-to-work and making-work-pay policies. But it also comprises elements to boost family incomes – higher benefit rates and increased collection of child support from absent parents – and a variety of measures to reduce the scarring effect



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of childhood deprivation.

As in the United States, welfare reform played little role in the most recent British elections. The Labor manifesto contains only one major addition to the social assistance agenda, a scheme for encouraging saving among pensioners coupled with a system of individual nesteggs to be established for every British newborn. The accounts would accumulate interest, and incentives would be created for contributions from each child's family and friends. The government's contribution would be larger for children in poor families. Use of the funds would be prohibited until age 18, when the accumulated wealth might be employed to investing in education, buying a home or setting up a business.

At the same time, less exciting but still important administrative changes continue apace. Shortly after the election, the government announced the merger of elements of what had been the Department of Education and Employment, and the Department of Social Security, to form a single Department of Work and Pensions, which integrates benefit and welfare-to-work programs. The official goal is to raise employment among lone parents from 50 percent to 70 percent by 2010. Well before the election, the government announced plans for revamping means-tested income subsidies for children and extending wage subsidies to low-income workers without children. This change, potentially the most dramatic of New Labor's spending initiatives, is scheduled for 2003.

## WHAT'S IN IT FOR AMERICA?

Suppose British practitioners had participated in *Five Years Into Welfare Reform: Lessons Learned and Models for the Future.* What might they have brought to the conclave? What might be the next developments in the Anglo-American trade in social policy?

The coming American debate over welfare reform will mostly focus on the re-funding of temporary assistance and the procedures used to determine state entitlement to federal support. This is a federalism issue that doesn't resonate with concerns in Britain's unitary government. But we think the congruence of British and American objectives in many areas of assistance policy and strategy will still foster collaboration. While the differences between both the rhetoric and ambition of New Labor and Republican Redux policies are now and will remain large, as one slides away from the surface to details, one glimpses issues of common interest:

**Incentives.** It is one thing to design a social assistance system that makes work pay. It is quite another to design one that makes *more* work pay. One of the purposes behind promoting the obligation to work is to compensate for the disincentives created by means-tested assistance systems. As is well known, the multiplication of such systems multiplies the disincentives, and this interaction is particularly perverse when benefits are large – as they are for beneficiaries with subsidized housing. Not surprisingly, British authorities have shown particular interest in American programs that raise employment among residents in the lowest-income public housing.

**The Transition to Work.** While both the American and British systems emphasize moving people from dependency to work, the month-to-month financial consequence is more readily apparent in the British system – in part because of the differences between its gain-as-you-earn Working Families Tax Credit program and America's gain-when-you-file earned-income tax credit. There is little systematic assessment of the benefits of alternative transitional support strategies; it would be possible through intermediaries to experiment in the United States with a



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benefits structure similar to that used in Britain, in which take-home pay is increased. Such experiments could also include alternative procedures for increasing access to food stamps.

**The Hard to Serve.** The precipitous decline of the welfare caseload in the United States has generated great concern about the status of departed families who may still be poor. Studies of such families have been conducted both by states and by independent researchers. Most report that a significant proportion – around 20 percent – of those exiting assistance do not sustain employment. Multiple problems, ranging from lack of skills to drug addiction, contribute to such experience. Families with barriers to self-support have always been part of the caseload, but until recently they were generally passed over when targets for employment policy were selected. Struggling families are a problem on both sides of the Atlantic; there may be gains from partnership in evaluating strategies for helping them.

**Youth.** Many of the principal concerns of the 1996 reforms – promoting work and marriage, reducing births outside marriage – typically involve young people. Yet for the most part, post-welfare reform programs directly affect young adults only after the fact. Thus states worry about fatherhood after fathering has occurred, about nonmarital births among women who are already mothers, about formation of two-parent families for people established as lone parents. Britain, by contrast, provides systematic support for people from 18 to 25 years old – support that promises opportunity and income to those who are willing to work, but that is not linked to parenthood. Britain's experience with New Deal for Young People would seem a worthy model for experimentation in high-poverty areas in America. Milwaukee's New Hope program, closely studied by British visitors, did offer earnings subsidies and job support for adults regardless of parental status. But no training was included.

**Management.** It is an article of faith in the United States that the federal system allows better tailoring of policy to local situations. While the gains actually realized from the American system may be questioned, it really does seem to be true that activist social assistance policy requires local discretion and flexibility because both the character of labor markets and the needs and capacities of clients differ.

Britain's New Deals are now largely delivered through one-stop centers based on American models and, as in the United States, advisers and caseworkers play central roles. Identifying the influence of program organization on outcomes at the local level is essential for understanding differences in performance across sites. While program details may differ, the core problems of governance are the same in both countries. Britain's more centralized system offers better opportunities for systematic experimentation.

As productive as collaboration on these matters of detail might be, motivation counts – and ultimately this turns on national leadership. While the British vision of welfare for the 21st century is surely far from complete, change is ongoing, and new institutions are under construction. From early on, New Labor's vision has been defined by an extremely effective mantra – "work for those who can, security for those who cannot." The American equivalent, "end welfare as we know it," is backward looking and no longer pertinent. The question remains whether a more fruitful approach – of necessity, one that fits centrist ideology in America – will be forthcoming.



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ALL PHOTOS: RICHARD S. CAREY

# Collector CARS

## Investment or Indulgence?

*By Richard S. Carey*

The collector car market has gone from boom to bust to recovery in the past decade. Meanwhile, dreams of easy riches have withered, revealing a basic truth: the market for collector cars is dominated by enthusiasts who value cars as historical artifacts and sources of recreation. Thus, while those who speculate in old cars occasionally make money, playing the collector car market for profit will probably prove to be a costly fling.

Old automobiles aren't simple investments. Unlike fine art, which does just fine hung on a wall or plunked on a plinth and treated to an occasional dusting



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and insurance premium payment, cars require storage, maintenance and regular exercise. Motivations for playing the old-car game range from possessing that which was unreachable in youth, to enjoying the pastime of restoration and tinkering, to being a part of history by owning a vehicle once driven by Juan Fangio – or even Elvis.

The wide scope here explains many seemingly irrational acts of buyers and sellers. For example, it's not uncommon to see a pristine car, just months out of the restorer's shop, offered for sale. Usually it has served its purpose (getting an invitation to Pebble Beach, Hurlingham or Bagatelle Concours d'Elegance) and is ready to be passed down the chain from a concours-oriented collector to one who will drive it proudly in tours and events. At Christie's recent auction in Tarrytown NY, the owner of a spotless 1957 Thunderbird that had won everything it could win, sold his pride and joy because, "I scraped, sanded, primed, painted and polished every square inch of its undercarriage, and I can't bear to drive it and think about it getting messed up." Presumably, the new owner will have no such qualms.

By the same token, fixer-uppers often bring surprising prices. Bonhams & Brooks sold a neglected Squire roadster at its August 2001 auction on California's Monterey peninsula for $134,500. Though a beautiful and very rare piece – one of only six survivors – it has little history, and in restored condition it will be worth little if any more than its purchase and restoration cost. Yet for the new owner, the process and the pride in saving, and eventually displaying, a nearly unique car is a large part of the ownership equation.

At other times cars sell for far more than comparable transactions suggest they are worth. In one memorable moment last year from the annual Barrett-Jackson auction, a bidder took home a beautifully restored '56 Chevrolet Bel Air convertible for $86,000 – $15,000 to $20,000 more than expected. But those who witnessed the event understand what happened. The successful bidder's wife turned to him with a smile as big as Joe E. Brown's, followed by the most sensual kiss ever seen at Barrett-Jackson.

### THE AUCTIONS – A CAPSULE HISTORY

The idea of auctioning collector cars is relatively new. It began in England, where Sotheby's held its first dedicated car sale in the mid-1960s. Christie's followed suit in short order. Parke Bernet began auctioning cars in the U.S. before its acquisition by Sotheby's.

Early auctions were held in cooperation with pioneer collectors like James Leake in the U.S. and Lord Montagu of Beaulieu in the U.K. In the 1960s and 1970s, collecting was a gentlemen's affair with cars trading among a small club-like group. Indeed, until the late-1960s collector car auctions routinely named the cars' purchasers in their published sales results – stark contrast to today's secretive world where anonymous bidders hide behind telephones. David Patridge, former head of Sotheby's car department, marks the February 1979 auction of the collection of Mayer L. "Bud" Cohn in Los Angeles as the moment when the collector car market shifted to a period of serious accumulation.

The market really only became visible to the mainstream media with the sale of the almost mythical collections of Bill Harrah in 1986. Harrah's holdings were vast and eclec-

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**RICK CAREY, who used to earn an honest living as the commercial director of Callaway Cars in Connecticut, is now a frequent contributor to *AutoWeek*, *Classic & Sports Car* and *Ferrari Market Letter*, on the subject of car collecting.**



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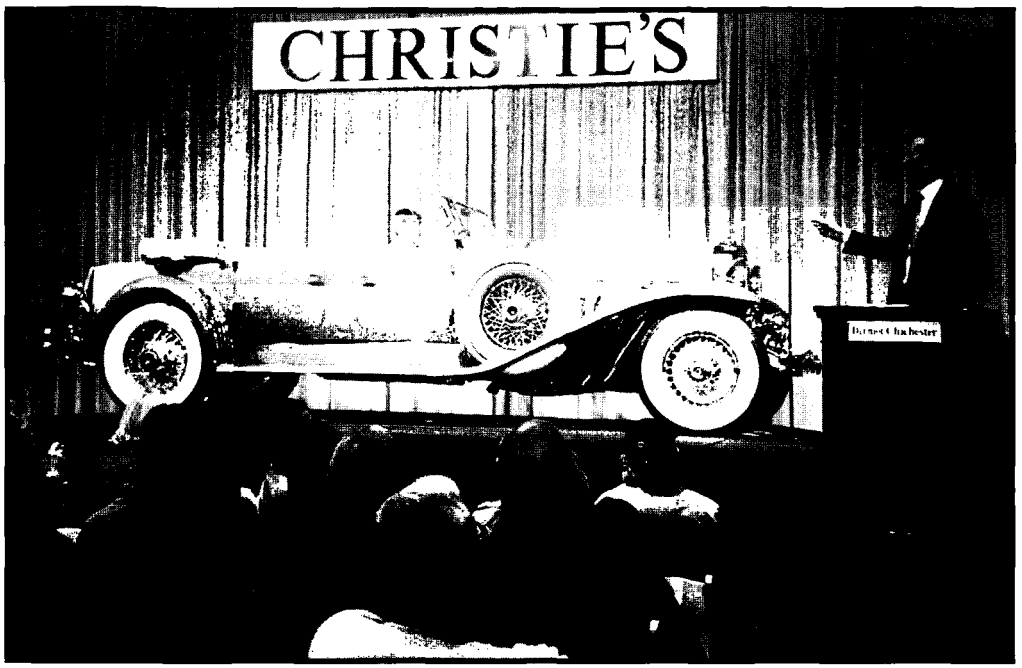


tic, from Model Ts to Bugatti Royales. Indeed, so many cars were stuffed into his warehouses in Reno, Nev. there was concern that their disposition would glut the market. Yet Harrah's cars brought high prices that seem barely reasonable even today, creating the core of several storied collections. The last of the four scheduled Harrah's sales, including the best cars in the collection, was never held. General William Lyon bought all of them in a single transaction for some $29 million.

The Harrah's sale launched a boom that would generate eight-figure prices at the peak. The frenzy was particularly acute for Ferraris. Enzo Ferrari's death in 1988 prompted speculators to bet that someone would pay large premiums for Ferraris manufactured before the company was taken over by Fiat. When it became apparent there weren't enough Ferraris around to satiate speculators' appetites, the mania spread to anything Italian.

But the bubble burst when speculators woke up to the reality that they'd been trading the most pricey cars among themselves. Sotheby's auction of the Rick Carroll collection in May 1990 effectively marked the end. Christie's managed to eke out a few sales at precollapse prices at Pebble Beach in August 1990, including a unique McLaren M6B GT for $1.32 million. (The McLaren's buyers were still trying to dig their way out from under it in 1998 when it was offered at RM's Monterey Sports Car Auction, but attracted a high bid of only $370,000.) Japanese buyers, who had accumulated collections of cars (as well as Impressionist paintings and first-growth Bordeaux wines) on the strength of soaring Tokyo real estate values and easy bank loans, simply vanished. The capital gains that had fueled American buyers dried up.

The market that followed in the early 1990s was so thin that it wasn't uncommon to see good cars offered with no takers. Enthusiasts, who just wanted fun wheels to tool around on weekends, to take to shows, or to race in vintage events, had been priced out of the market. Those who did have serious money to invest had no idea what the cars were worth, and sat on their wallets waiting for enlightenment.

The 1991-93 period was one of retrench-



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ment as prices plunged and the plungers eventually swallowed seven-figure losses. Then, gradually, the market recovered. Today it's surprisingly healthy and active, given the recent softness of the economy.

### AUCTIONS TRANSACTIONS

Auctions are the only resource for publicly announced transactions in the collector car market. Experience has shown their results to be consistent, and in retrospect many transactions that were questioned when first reported have stood up well in the glare of hindsight.

The Barrett-Jackson auction is held each January in Scottsdale, Ariz. It began in 1972 and has the longest continuous history under consistent management in the same location. B-J has become known for the catholicity of its offerings and its stature as the bellwether of each year's collector car market. In 2001, its 30th year, B-J sold 83.8 percent of the cars that rolled across its auction block, ringing up a total of $26.7 million in sales.

B-J's first auction was organized by classic car dealer Tom Barrett and collector Russ Jackson. Held at Scottsdale High School, 40 cars – mostly from Tom's and Russ' own collections – were offered. No one remembers how many were sold, but the auction brought in about $650,000 (about $2.8 million in today's money). By the mid-1970s, B-J was doing over $1 million in sales. Its transactions faltered in the early 1980s, then began to pick up steadily. The graph (page 67) shows results for the past 22 years in both absolute amounts and inflated to January 2001 prices.

In recent years B-J has benefited both from the market's recovery and from Craig Jackson's vision of creating an event around the auction. The auction offers vast numbers of high quality, accessible cars, largely without minimum-reserve bids. Buyers can feel confident that the cars are really for sale, not brought for show or to create some phony legend by being bid up by shills. The formula has paid off. In 1982 there were 0.92 registered bidders for every car offered. By 1988 that had grown to 1.13. This year there were 3.77 registered bidders per car offered – 3 times as many as in 1988.

Christie's U.S. sales moved around until management noted the success Rick Cole was having with an annual auction on the Monterey peninsula during the Pebble Beach Concours d'Elegance/Monterey Historic Races weekend. After that, Christie's established its own sale at Pebble Beach in 1990. The market was diving into the previously described crater, but Christie's persistence and deep pockets overcame its bad timing, and "Christie's Pebble Beach" has become a great success. In 2000, it sold 98 of 112 cars offered (including the bulk of two major collections) for a total of $26.5 million in just over four hours.

Sales at Christie's Pebble Beach are hard to analyze because of the irregular appearance of blockbuster cars and major collections:

- In 1990, 10 cars of only 26 offered were sold, yet nine of them brought over $250,000 in the last gasps of the late-1980s frenzy.
- In 1995, the "Rimoldi Alfa" 8C 2300 Touring-bodied Spider (sold by Christie's in 1989 at Monaco for – ouch – $2.958 million) brought $1.8 million. Raymond Lutgert's parade of 15 spectacular Rolls-Royces, 11 of which brought six-figure prices, added depth. The CPI-adjusted median sale was $121,200.
- In 2000, a Ferrari 330/P3 (the most voluptuous of all Ferrari racing cars) copped $5.616 million. Two collections, of Bob Sutherland and Matt and Barbara Browning, made up much of the balance of the sale in which the quality and reputation of their cars



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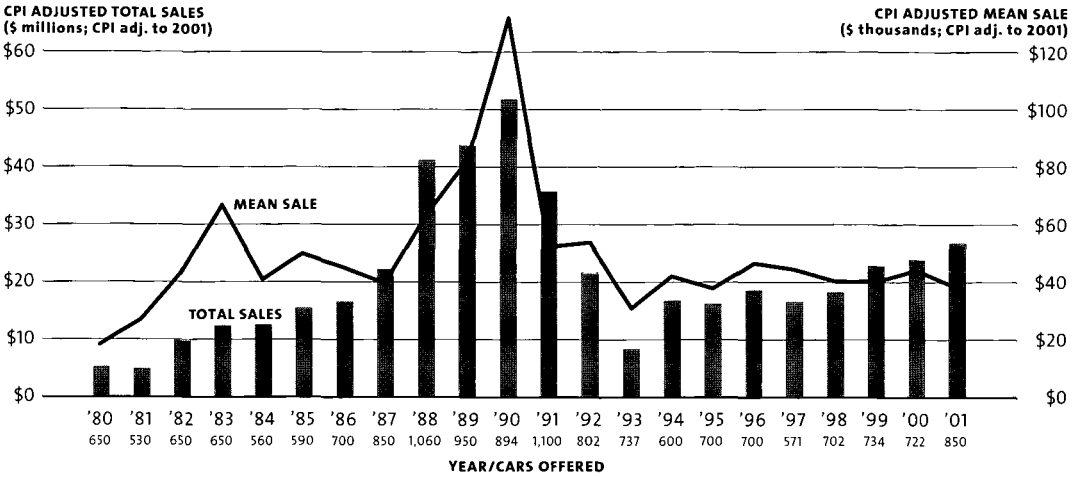
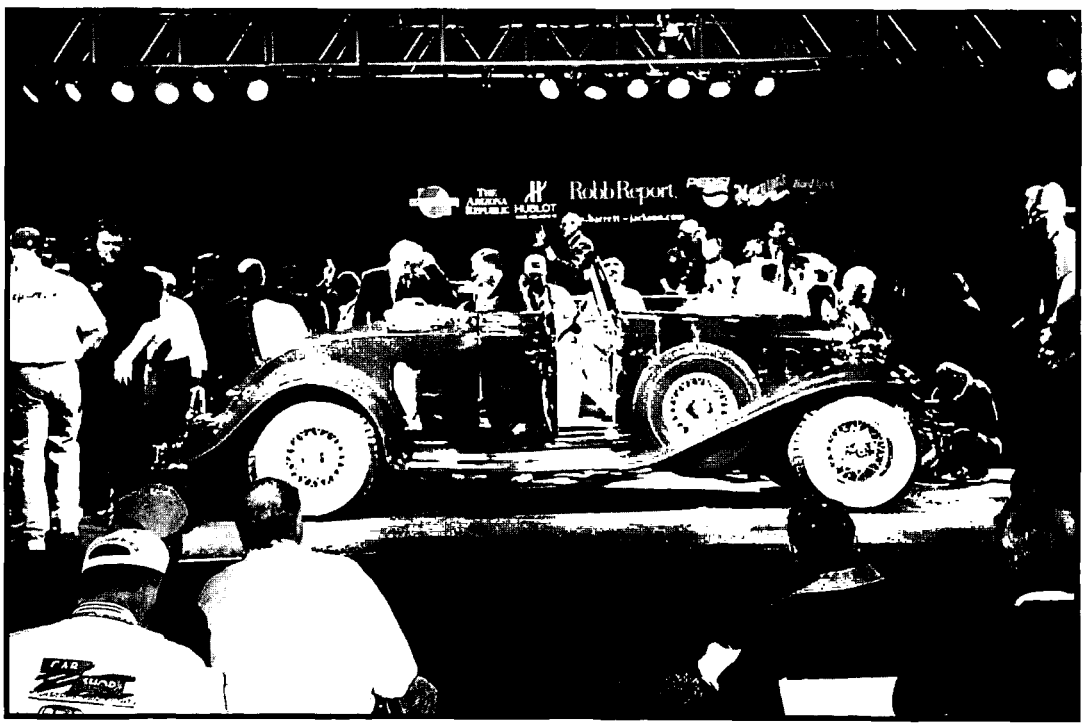
**BARRETT-JACKSON AUCTION, SCOTTSDALE, ARIZONA**

**CPI ADJUSTMENT BASE JANUARY 2001**




brought outstanding prices. Fifteen cars of the 112 offered brought over $500,000 each.

• The 2001 auction, the first after the dot-com collapse, brought a return to reality. Cars consigned were down by 25%. The sale's performance plunged to a 64.7 percent sale rate, in some measure burdened by a collection of Indy cars that attracted little interest. More



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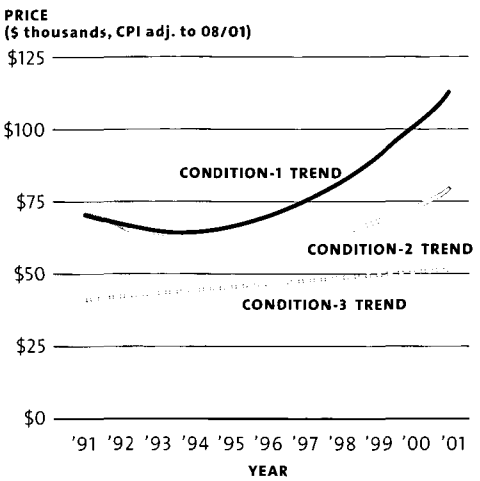
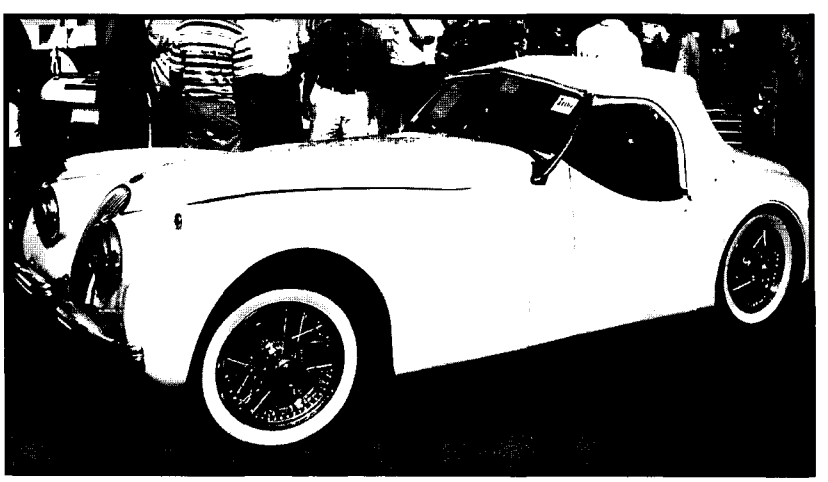
**JAGUAR XK 120 ROADSTER PRICES**
**CPI ADJUSTED TO AUGUST 2001**




*(53 transactions: 43 U.S., 10 Europe)*



cars were sold under Christie's low estimate than over the high. The median sale, however, was a healthy $110,500.

Enthusiasts this past summer were less willing to step up to top-dollar bids. Collectors in Japan and Europe still send cars to the U.S. (a flow amply demonstrated in Monterey) where they sop up as much of collectors' liquidity as they can, accepting modest U.S. market prices in relatively strong U.S. dollars.

At the same time, there remains ample liquidity among collectors for the very best cars. Machinery of impeccable provenance, great beauty, superb condition and technical refinement still draws buyers like bees to nectar. Examples from Monterey are plentiful, whether they are fantastic Ferraris (RM's 410 Sport, the weekend's top sale at $3.9 million), beautiful Bugattis (Bonhams & Brooks' Type 57S Atalante), marvelous Mercedes-Benzes (Christie's 540K Cabriolet) or famous Ford race cars (Russo & Steele's ex-Bud Moore Trans Am Mustang).

Sales totals are still impressive. But the composition of the sales' consignments has changed to high quality but lower priced models accessible to larger numbers of collectors. This more diverse market is inherently more stable than one heavily dependent upon a few deep-pocketed collectors and high-rolling speculators.

## SELECTED MARQUES AND MODELS

In the world of collector cars some features are much more desirable than others, which sometimes yield order-of-magnitude differences in market value between otherwise similar models. Condition and originality also contribute to value. Individual transactions are fraught with subjective considerations of time, place, presentation and configuration. To minimize these variations, I've selected a few popular collector cars that appear frequently with common characteristics and enough sales to be representative. Each of these cars is essentially like



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the others except for condition.

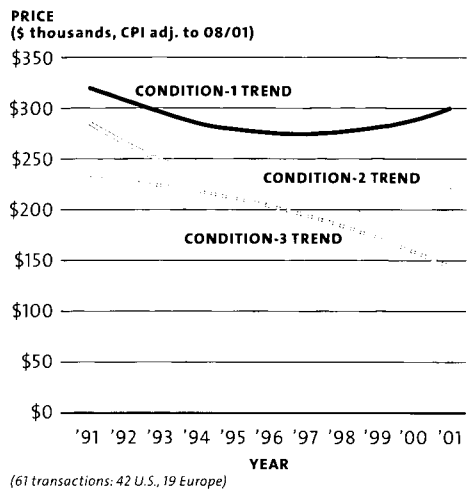
Condition, of course, is important. Dave Brownell originated a condition grading scheme when he was editor of *Old Cars Weekly*. It's simple and has become widely accepted, rating cars' conditions on a 1-5 scale as follows:

1. Perfect to an extent that's better than the car was when delivered.
2. As it would have been displayed on a dealer's showroom when new.
3. Presentable and fully functional.
4. Flawed in some serious degree.
5. Rough, not running or seriously damaged, or deteriorated.

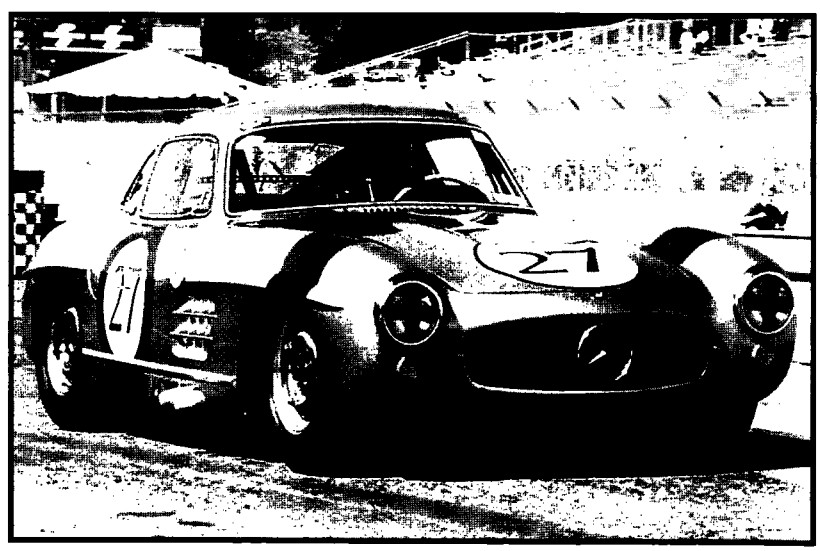
The auctions see a lot of 3s, a fair number of 2s and a few 1s. The 4s and 5s are rare at auction, simply because buyers faced with a good selection of well presented, usable cars turn their backs on all but the most intriguing project cars. Observers' condition evaluations are highly consistent over time.

**MERCEDES BENZ 300SL GULLWING PRICES**

**CPI ADJUSTED TO AUGUST 2001**




*(61 transactions: 42 U.S., 19 Europe)*



Jaguar XK 120s are staples of the collector car hobby. Restorers have ample experience and parts supplies, so maintenance, repairs and restorations can be consistent. That shows in the reported transactions. XK 120 Roadsters mirror almost exactly the qualitative impression of the market's performance: a depression in the early 1990s followed by recovery since '95 or '96. These data show a steady increase following the post-frenzy confusion with the greatest strength in the high quality show and near-show condition cars.

Mercedes-Benz Gullwings bring four times the prices of XK 120s. They're one of few mid-six-figure cars to be produced in some quantity that show up at auction frequently with consistent specifications.

The Gullwing data reveals today's strong preference for cars in very good condition. The declining trend line for condition-3 cars shouldn't suggest their prices are going through the floor, but rather that the



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**FERRARI 275 GTB PRICES**
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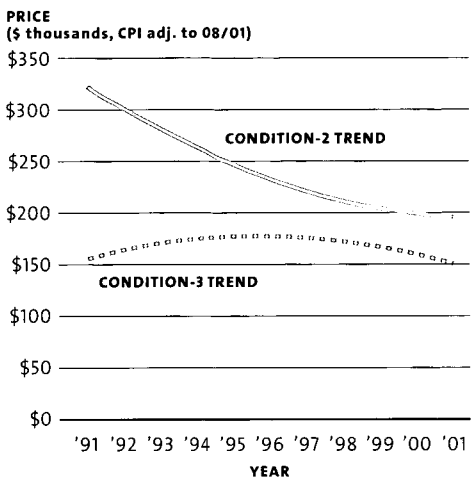


*(19 transactions: 8 U.S., 11 Europe)*

preference of low-six-figure buyers is for sound cars that can be driven with both confidence and pride. It often takes a big wad of cash to make iffy Gullwings reliable and presentable. Spending a known amount for cars that have already had their shortcomings remedied reflects an economically rational preference for minimizing the risk of expensive work on shaky examples.

[Note: The transactions on which the graph is based are "plain" 275 GTBs: 3-carb, 2-cam cars with steel bodies.]

Ferrari 275 GTBs get everyone's juices flowing. It is one of Italian car-body designer Pininfarina's most alluring shapes and it's the last of Ferrari's front-engine V12-powered production cars that could be driven off the showroom floor directly to the race track with good prospects of success. The alarming plunge in values of condition-2 275 GTBs tells the story of production Ferraris' values following the late-1980s frenzy. 365 GTB/4 Daytonas' values look even worse. Values of 275 GTBs have stabilized in the $200,000 range over the past couple of years, supported by their seductive shape.

The 1955 Thunderbird had few options and most appear in very consistent trim. '57 'Birds may be more sexy, but their expanded options list makes comparison impractical. The performance of condition-2s and 3s is clear. Their CPI-adjusted values cratered in the early 1990s and have only just climbed back to break-even. Unlike Ferrari 275 GTBs, however, the '55 T-birds' decline barely ventured into five figures in real dollars, and a 1990 buyer has had a decade's enjoyment of a charismatic and affordably maintained machine.

The transaction histories presented here are supported by much other data, all showing comparable trends. The frothy market of the late 1980s carried over to a few transactions at high prices in the early 1990s, settled down to build a new base from 1993-95, then began a slow increase that has brought inflation-adjusted prices nearly to their early 1990s levels in the past two years. Today's dol-



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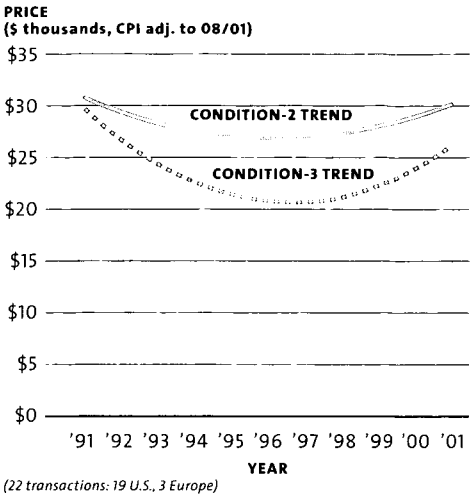
lars buy just about as much collector car as they bought a decade ago – nice to know if you enjoy cars, but bad news for folks who think of them as investments.

The cars, overall, have improved in quality and presentation. There is no shortage of good cars. And buyers who once stood on their financial toes to grab a shaky Ferrari 275 GTB now appear willing to purchase a very good 365 GTB/4 Daytona instead. The speculators of the late 1980s, who flipped cars like pancakes at IHOP, are gone, replaced by car enthusiasts who are using their purchases for vintage racing, rallying and touring.

**1955 THUNDERBIRD PRICES**

**CPI ADJUSTED TO AUGUST 2001**




*(22 transactions: 19 U.S., 3 Europe)*

## CONCLUSION

There are plenty of accurate anecdotes about collectors who've hit home runs in cars. Used but uncompetitive Cobra Daytona Coupes have changed hands for a few thousand dollars and are worth $4 million today. These are, however, the rare exceptions. Once in a while a collector's choice will turn out to be a prescient investment, but that is the exception. The rule is that car collectors are enthusiasts who buy cars that give them pleasure from ownership and use, not for financial gain or inflation hedge. Eventually they will sell their cars into a market of other like-minded enthusiasts who will value their acquisitions in essentially the same way they were valued when acquired: in terms of recreational value.

Collecting cars doesn't stack up well as an investment, even buying when the market is weak. As is clear from the graphs, the return on investment in the 1990s was positive, but nothing to crow about. Early signs from the current slowdown indicate values are climbing even more slowly, if at all, than in the recent past. As an avocation, however, there may be few other ways to have so much fun, meet so many good people, visit such neat places as honored guests and participate in the preservation of an important part of modern history at such reasonable cost and acceptable risk. M



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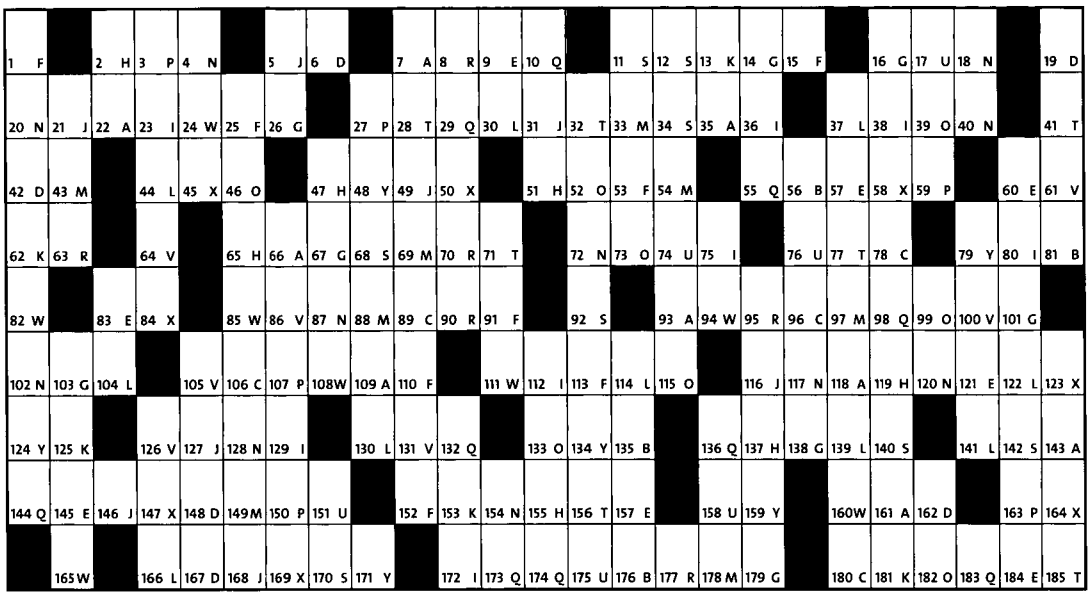
# PUZZLER

**BY STEVEN POSTREL**




*After answering each clue, copy the letters to the corresponding numbers in the grid, where they will form a quotation. Words begin and end at shaded squares, and so may continue from one row to the next. The first letters of each answer, when spelled in order, give the author and publication of the quotation.*

*Answers on page 95*

A. Unlikely to be dietetic (2 words)

93 35 161 22 143 66 7 109 118

B. Always 135 56 176 81

C. Eisenhower's post (abbr.) 180 89 106 78 96

D. Demur (2 words) 167 19 162 6 42 148

E. Rocked precariously 60 121 9 83 184 145 57 157

F. Aligned 113 91 1 53 152 25 15 110

G. Movie with Buzz (2 words) 101 67 179 138 16 103 14 26

H. North Atlantic denizen 2 137 47 155 119 65 51

I. Weights 38 75 172 112 80 129 23 36

J. Revealing jewelry (2 words) 146 21 127 31 168 116 5 49

K. Land formerly split into North and South 181 153 62 13 125

L. Flexible workgroup (2 words)

122 37 141 30 104 114 130 139 166 44

M. Sounds like a bird 43 54 149 178 88 97 33 69

N. Radical feminist goal (3 words)

18 117 4 87 72 128 40 120 102 154 20

O. Comes back to earth 73 46 115 52 133 99 39 182

P. Kwa speakers 59 150 107 163 27 3

Q. Direct (2 words) 174 98 132 55 173 10 136 144 29 183

R. Source of inflow 95 63 90 8 70 177

S. Legendary Texas weapon 140 12 170 34 142 68 92 11

T. Insect posterior section 32 41 71 28 185 156 77

U. Tiny flash 175 17 74 158 76 151

V. Facing a dilemma (3 words) 61 86 131 105 64 100 126

W. Pink-flowered tree 111 165 82 85 24 94 160 108

X. Bit of popular wisdom 147 164 45 84 58 123 50 169

Y. Exfoliator 171 48 159 79 124 134



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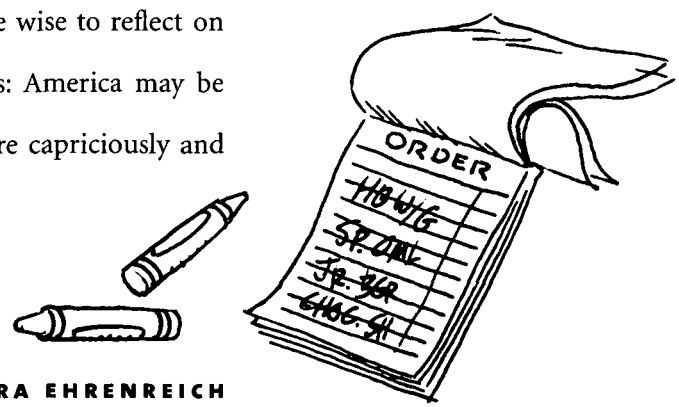
# Nickel and Dimed

## On (not) getting by in America

ILLUSTRATIONS BY
FRED INGRAM

Barbara Ehrenreich, pundit from the left and author of the best-selling *Nickel and Dimed: On (Not) Getting by in America* (Metropolitan Books),* is one of America's most reliable critics of the rich and powerful. But even those who are inclined to think too much of money and power have been heard to admit that Ehrenreich's political medicine goes down easy, thanks in large part to her delicious sense of humor and refreshing lack of self-importance. ¶ This excerpt from *Nickel and Dimed* chronicles her initial effort to live as an unskilled worker in contemporary America. A stunt? Sure. But those tempted to write it off as an exercise in bleeding-heart liberalism would be wise to reflect on the embarrassing truth it explores: America may be rich, but the fruits of its wealth are capriciously and unevenly distributed.




BY BARBARA EHRENREICH

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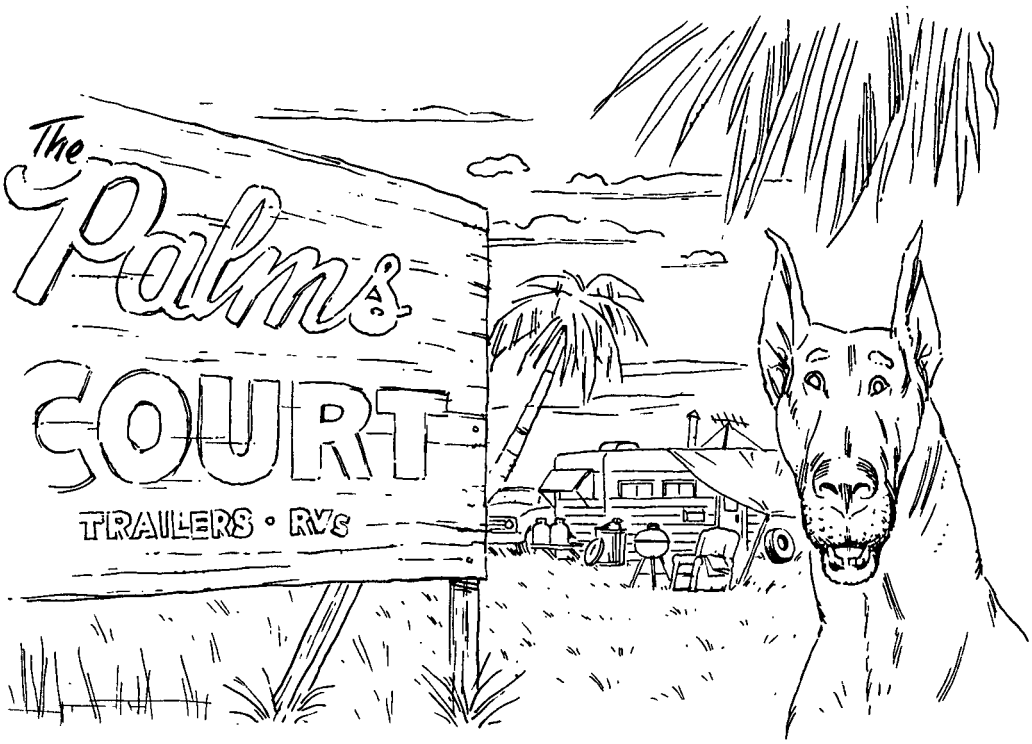


**Mostly out of laziness,** I decide to start my low-wage life in the town nearest to where I actually live, Key West, Fla., which, with a population of about 25,000 is elbowing its way up to the status of a genuine city. The downside of familiarity, I soon realize, is that it's not easy to go from being a consumer, thoughtlessly throwing money around in exchange for groceries and movies and gas, to being a worker in the very same places. I am terrified, especially at the beginning, of being recognized by some friendly business owner or erstwhile neighbor and having to stammer out some explanation of my project. Happily, though, my fears turn out to be entirely unwarranted: during a month of poverty and toil, no one recognizes my face or my name, which goes unnoticed and for the most part unuttered. In this parallel universe, I am "baby," "honey," "blondie" and, most commonly, "girl."



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My first task is to find a place to live. I figure that if I can earn $7 an hour – which, from the want ads, seems doable – I can afford to spend $500 on rent or maybe, with severe economies, $600, and still have $400 or $500 left over for food and gas. In the Key West area, this pretty much confines me to flophouses or trailer homes – like the one, a pleasing 15-minute drive from town, that has no air-conditioning, no screens, no fans, no television, and, by way of diversion, only the challenge of evading the landlord's Doberman pinscher. The big problem with this place, though, is the rent, which at $675 a month is well beyond my reach. All right, Key West is expensive. Still, it is a shock to realize that trailer trash has become, for me, a demographic category to aspire to.

So I decide to make the common trade-off between affordability and convenience and go for a $500-a-month efficiency 30 miles up a two-lane highway from the employment opportunities of Key West, meaning 45 minutes if there's no road construction and I don't get caught behind some sun-dazed Canadian tourists. I hate the drive, along a roadside studded with white crosses commemorating the more effective head-on collisions, but it leads to a sweet little place – a cabin, more or less, set in the swampy backyard of the converted mobile home where my landlord, an affable TV repairer, lives with his bartender girlfriend.

The next piece of business is to comb through the want ads and find a job. I rule out various occupations for one reason or another: hotel front-desk clerk, for example, which to my surprise is regarded as unskilled and pays only $6 or $7 an hour, gets eliminated because it involves standing in one spot for eight hours a day. Waitressing is also something I'd like to avoid, because I remember it leaving me bone-tired when I was 18, and I'm decades of varicosities and back pain beyond that now. Telemarketing, one of the first refuges of the suddenly indigent, can be dismissed on grounds of personality. This leaves certain supermarket jobs, such as deli clerk, or housekeeping in the hotels and guest houses, which pays about $7 and, I imagine, is not too different from what I've been doing part time, in my own home, all my life.

So I put on what I take to be a respectable-looking outfit of ironed Bermuda shorts and scooped-neck T-shirt and set out for a tour of the local hotels and supermarkets. Best Western, Econo Lodge, and HoJo's all let me fill out application forms, and these are, to my relief, mostly interested in whether I am a legal resident of the United States and whether I have committed any felonies. My next stop is Winn-Dixie, the supermarket, which turns out to have a particularly onerous application process, featuring a 20-minute interview by computer since, apparently, no human on the premises is deemed capable of representing the corporate point of view. I am conducted to a large room decorated with posters illustrating how to look professional (it helps to be white and, if female, permed) and warning about the slick promises that union organizers might try to tempt me with. The interview is multiple-choice: do I have anything, such as child-care problems, that might make it hard for me to get to work on time? Do I think safety on the job is the responsibility of management? Then, popping up cunningly out of the blue: how many dollars' worth of stolen goods have I purchased in the last year? Would I turn in a fellow employee if I caught him stealing? Finally, "are you an honest person?"

Apparently I ace the interview, because I am told that all I have to do is show up in some doctor's office tomorrow for a urine test. This seems to be a fairly general rule: if



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you want to stack Cheerios boxes or vacuum hotel rooms in chemically fascist America, you have to be willing to squat down and pee in front of a health worker (who has no doubt had to do the same thing herself.) The wages Winn-Dixie is offering – $6 and a couple of dimes to start with – are not enough, I decide, to compensate for this indignity.

I lunch at Wendy's, where $4.99 gets you unlimited refills at the Mexican part of the Super-bar, a comforting surfeit of refried beans and cheese sauce. Then it's off for a round of the locally owned inns and guest houses in Key West's Old Town, which is where all the serious sightseeing and guzzling goes on, a couple of miles removed from the functional end of the island, where the discount hotels make their homes. At The Palms, let's call it, a bouncy manager actually takes me around to see the rooms and meet the current housekeepers, who, I note with satisfaction, look pretty much like me – faded ex-hippie types in shorts with long hair pulled back in braids. Mostly, though, no one speaks to me or even looks at me except to proffer an application form.

Three days go by like this and, to my chagrin, no one from the approximately 20 places at which I've applied calls me for an interview. I had been vain enough to worry about coming across as too educated for the jobs I sought, but no one even seems interested in finding out how overqualified I am. Only later will I realize that the want ads are not a reliable measure of the actual jobs available at any particular time. They are the employers' insurance policy against the relentless turnover of the low-wage work force. Most of the big hotels run ads almost continually, if only to build a supply of applicants to replace the current workers as they drift away or are fired. So finding a job is just a matter of being both in the right place at the right time and flexible enough to take whatever is being offered that day.

**"That's just Billy. He's on the rag again" – a condition occasioned, in this instance, by the fact that the cook on the morning shift had forgotten to thaw out the steaks.**

This finally happens to me at one of the big discount-chain hotels where I go, as usual, for housekeeping and am sent instead to try out as a waitress at the attached family restaurant, a dismal spot looking out on a parking garage, which is featuring "Pollish sausage and BBQ sauce" on this 95-degree day. Phillip, the dapper young West Indian who introduces himself as the manager, interviews me with about as much enthusiasm as if he were a clerk processing me for Medicare, the principal questions being what shifts I can work and when I can start. I mutter about being woefully out of practice as a waitress, but he's already on to the uniform. I'm to show up tomorrow wearing black slacks and black shoes; he'll provide the rust-colored polo shirt with Hearthside, as we'll call the place, embroidered on it, though I might want to wear my own shirt to get to work, ha ha.

So begins my career at the Hearthside, where for two weeks I work from 2 till 10 p.m. for $2.43 an hour plus tips. Employees are



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barred from using the front door, so I enter the first day through the kitchen, where a red-faced man with shoulder-length blond hair is throwing frozen steaks against the wall.

"That's just Billy," explains Gail, the wiry middle-aged waitress who is assigned to train me. "He's on the rag again" – a condition occasioned, in this instance, by the fact that the cook on the morning shift had forgotten to thaw out the steaks. For the next eight hours, I run after the agile Gail, absorbing bits of instruction along with fragments of personal tragedy. All food must be trayed, and the reason she's so tired today is that she woke up in a cold sweat thinking of her boyfriend, who was killed a few months ago in a scuffle in prison. No refills on lemonade. And the reason he was in prison is that a few DUIs caught up with him, that's all, could have happened to anyone. Carry the creamers to the table in a monkey bowl, never in your hand. And after he was gone she spent several months living in her truck, peeing in a plastic bottle and reading by candlelight at night, but you can't live in a truck in the summer, since you need to have the windows down, which means anything can get in, from mosquitoes on up.

At least Gail puts to rest any fears I had of appearing overqualified. From the first day on, I find that of all the things that I have left behind, such as home and identity, what I miss the most is my competence. I am beset by requests as if by bees: more iced tea here, ketchup over there, a to-go box for table 14, and where are the high chairs, anyway? Of the 27 tables, up to 6 are usually mine at any time, though on slow afternoons or if Gail is off, I sometimes have the whole place to myself.

Then there is the touch-screen-computer

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ordering system to master, which I suppose is meant to minimize server-cook contacts but in practice requires constant verbal fine-tuning: "That's gravy on the mashed, OK? None on the meat loaf," and so forth. And, something I had forgotten in the years since I was 18: about a third of a server's job is side work invisible to customers – sweeping, scrubbing, slicing, refilling and restocking. If it isn't all done, every little bit of it, you're going to face the 6 p.m. dinner rush defenseless, and probably go down in flames. I screw up dozens of times at the beginning, sustained in my shame entirely by Gail's support – "It's OK, baby, everyone does that sometime" – because, to my total surprise and despite the scientific detachment I am doing my best to maintain, I care.

When I wake up at 4 a.m. in my own cold sweat, I am not thinking about the writing deadlines I'm neglecting; I'm thinking of the table where I screwed up the order and one of the kids didn't get his kiddie meal until the rest of the family had moved on to their Key lime pies. That's the other powerful motivation – the customers, or patients, as I can't help thinking of them, on account of a mysterious vulnerability that seems to have left them temporarily unable to feed themselves. After a few days at Hearthside, I feel the service ethic kick in like a shot of oxytocin, the nurturance hormone. The plurality of my customers are hard-working locals – truck drivers, construction workers, even housekeepers from the attached hotel – and I want them to have the closest to a fine dining experience that the grubby circumstances will allow.

There is Benny, for example, a short, tight-muscled sewer repairman who cannot even think of eating until he has absorbed a half hour of air-conditioning and ice water. We chat about hyperthermia and electrolytes until he is ready to order some finicky combination like soup of the day, garden salad, and a side of grits. There are the German tourists who are so touched by my pidgin "Wilkommen" and "Ist alles gut?" that they actually tip. (Europeans, no doubt spoiled by their trade-union-ridden, high-wage welfare states, generally do not know that they are supposed to tip. Some restaurants, the Hearthside included, allow servers to "grat" their foreign customers, or add a tip to the bill. Since this amount is added before the customers have a chance to tip or not tip, the practice amounts to an automatic penalty for imperfect English.)

At Hearthside, we utilize whatever bits of autonomy we have to ply our customers with the illicit calories that signal our love. It is our job as servers to assemble the salads and desserts, pour the dressings, and squirt the whipped cream. We also control the number of butter pats our customers get and the amount of sour cream on their baked potatoes. So if you wonder why Americans are so obese, consider the fact that waitresses both express their humanity and earn their tips through the covert distribution of fats.

Ten days into it, this is beginning to look like a livable lifestyle. I like Gail, who says she is looking at 50, age-wise, but moves so fast she can alight in one place and then another without apparently being anywhere between. I clown around with Lionel, the teenage Haitian busboy, though we don't have much vocabulary in common, and I loiter near the main sink to listen to the older Haitian dishwashers' musical Creole, which sounds, in their rich bass voices, like French on testosterone. I bond with Timmy, the 14-year-old white kid who clears tables at night, by telling him I don't like people putting their baby seats right on the tables; it makes the baby look too much like a side dish.



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I especially like Joan, the svelte 40-ish hostess who turns out to be a militant feminist, pulling me aside one day to explain that "men run everything – we don't have a chance unless we stick together." Accordingly, she backs me up when I get overpowered on the floor, and in return I give her a chunk of my tips or stand guard while she sneaks off for an unauthorized cigarette break.

I finish up every night at 10 or 10:30, depending on how much of the side work I've been able to get done during the shift, and cruise home listening to the tapes I snatched at random when I left my real home. To bed by 1:30 or 2, up at 9 or 10, read for an hour while my uniform whirls around in the landlord's washing machine, and then it's another eight hours spent following Mao's central instruction as laid out in the Little Red Book, which was: serve the people. I could drift along like this, in some dreamy proletarian idyll, except for two things. One is management. If I have kept this subject to the margins so far it is because I still flinch to think that I spent all those weeks under the surveillance of men (and later women) whose job it was to monitor my behavior for signs of sloth, theft, drug abuse or worse.

Managers can sit – for hours at a time, if they want – but it's their job to see that no one else ever does, even when there's nothing to do, and this is why, for servers, slow times can be as exhausting as rushes. You start dragging out each little chore because if the manager



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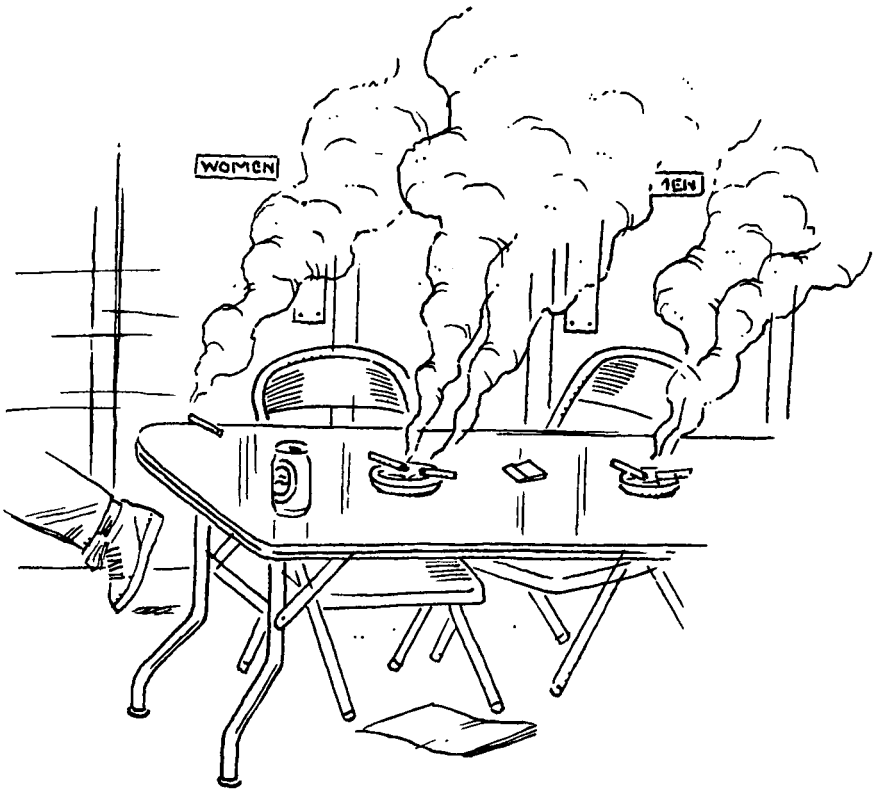


on duty catches you in an idle moment he will give you something far nastier to do. So I wipe, I clean, I consolidate ketchup bottles and recheck the cheesecake supply, even tour the tables to make sure the customer-evaluation forms are all standing perkily in their places.

On my first Friday at Hearthside there is a "mandatory meeting for all restaurant employees," which I attend, eager for insight into our overall marketing strategy and the niche (your basic Ohio cuisine with a tropical twist?) we aim to inhabit. But there is no "we" at this meeting. Phillip, our top manager except for an occasional consultant sent out by corporate headquarters, opens it with a sneer: "The break room – it's disgusting. Butts in the ashtrays, newspapers lying around, crumbs." This windowless little room, which also houses the time clock for the entire hotel, is where we stash our bags and civilian clothes and take our half-hour meal breaks. But a break room is not a right, he tells us. It can be taken away.

We should also know that the lockers in the break room and whatever is in them can be searched at any time. Then comes gossip: there has been gossip; gossip (which seems to mean employees talking among themselves) must stop. Off-duty employees are henceforth barred from eating at the restaurant, because "other servers gather around them and gossip." When Phillip has exhausted his agenda of rebukes, Joan complains about the condition of the ladies' room and I throw in my two bits about the vacuum cleaner. But I don't see any backup coming from my fellow servers, each of whom has slipped into her own personal funk.

Just four days later we are suddenly summoned into the kitchen at 3:30 p.m., even though there are live tables on the floor. We all – about 10 of us – stand around Phillip, who announces grimly that there has been a



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report of some "drug activity" on the night shift and that, as a result, we are now to be a drug-free workplace, meaning that all new hires will be tested and possibly also current employees on a random basis. I am glad that this part of the kitchen is so dark because I find myself blushing as hard as if I had been caught toking up in the ladies' room myself. I haven't been treated this way – lined up in the corridor, threatened with locker searches, peppered with carelessly aimed accusations – at least since junior high school. Back on the floor, Joan cracks, "Next they'll be telling us we can't have sex on the job."

When I ask Stu, the assistant manager, what happened to inspire the crackdown, he just mutters about "management decisions" and takes the opportunity to upbraid Gail and me for being too generous with the rolls. From now on, there is to be only one per customer and it goes out with the dinner, not with the salad. He's also been riding the cooks, prompting Andy to come out of the kitchen and observe – with the serenity of a man whose customary implement is a butcher knife – that "Stu has a death wish today."

The other problem, in addition to the less-than-nurturing management style, is that this job shows no sign of being financially viable. You might imagine, from a comfortable distance, that people who live, year in and year out, on $6 to $10 an hour have discovered some survival stratagems unknown to the middle class. But no. It's not hard to get my coworkers talking about their living situations, because housing, in almost every case, is the principal source of disruption in their lives, the first thing they fill you in on when they arrive for their shifts.

When Gail and I are wrapping silverware in napkins – the only task for which we are permitted to sit – she tells me she is thinking of escaping from her roommate by moving into the Days Inn. I am astounded: how can she even think of paying $40 to $60 a day? But if I was afraid of sounding like a social worker, I have come out just sounding like a fool. She squints at me in disbelief: "And where am I supposed to get a month's rent and a month's deposit for an apartment?"

There are no secret economies that nourish the poor; on the contrary, there are a host of special costs. If you can't put up the two months' rent you need to secure an apartment, you end up paying through the nose for a room by the week. If you have only a room, with a hotplate at best, you can't save by cooking up huge lentil stews that can be frozen for



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the week ahead. You eat fast food or the hot dogs and plastic-foam cups of soup that can be microwaved in a convenience store. If you have no money for health insurance – and the Hearthside's niggardly plan kicks in only after three months – you go without routine care or prescription drugs and end up paying the price. Gail, for example, was doing fine, health-wise anyway, until she ran out of money for estrogen pills. She is supposed to be on the company health plan by now, but they claim to have lost her application form and say they are beginning the paperwork all over again. So she spends $9 a pop for pills to control the migraines she wouldn't have, she insists, if her estrogen supplements were covered.

My own situation, when I sit down to assess it after two weeks of work, would not be much better if this were my actual life. The seductive thing about waitressing is that you don't have to wait for payday to feel a few bills in your pocket, and my tips usually cover meals and gas, plus something left over to stuff into the kitchen drawer I use as a bank. But as the tourist business slows in the summer heat, I sometimes leave work with only $20 in tips. (The gross is higher, but servers share about 15 percent of their tips with the busboys and bartenders.) With wages included, this amounts to about the minimum wage of $5.15 an hour. The sum in the drawer is piling up, but at the present rate of accumulation will be more than $100 short of my rent when the end of the month comes around. Nor can I see any expenses to cut. I do make my lunch almost every day – usually some slow-burning, high-protein combo like frozen chicken patties with melted cheese on top and canned pinto beans on the side. Dinner is at the Hearthside, which offers its employees a choice of a BLT or fish sandwich, or a hamburger, for only $2. The burger lasts longest, especially if it's heaped with gut-puckering jalapeños, but by midnight my stomach is growling again.

So unless I want to start using my car as a residence, I have to find a second or an alternative job. I call all the hotels at which I'd filled out housekeeping applications weeks ago – the Hyatt, Holiday Inn, Econo Lodge, HoJo's, Best Western, plus a half dozen locally run guest houses. When I finally get a positive response, I have been identified once again as server material. Jerry's – again, not the real name – which is part of a well-known national chain and physically attached to another budget hotel, is ready to use me at once. The prospect is both exciting and terrifying, because, with about the same number of tables and counter seats, Jerry's attracts three or four times the number of customers the gloomy old Hearthside does.

Picture a fat person's hell, and I don't mean a place with no food. Instead, there is everything you might eat if eating had no bodily consequences – the cheese fries, the chicken-fried steaks, the fudge-laden desserts – only here every bite must be paid for, one way or another, in human discomfort. The kitchen is a cavern, a stomach leading to the lower intestine that is the garbage and dishwashing area, from which issue bizarre smells combining the edible and the offal – creamy carrion, pizza barf, and that unique and enigmatic Jerry's scent: citrus fart. The floor is slick with spills, forcing us to walk through the kitchen with tiny steps, like Susan McDougal in leg irons.

The break room summarizes the whole situation: there is none, because there are no breaks at Jerry's. For six to eight hours in a row, you never sit except to pee. Actually, there are three folding chairs at a table immediately adjacent to the bathroom, but hardly anyone ever sits in this, the very rectum of the gastro-architectural system. Rather, the func-



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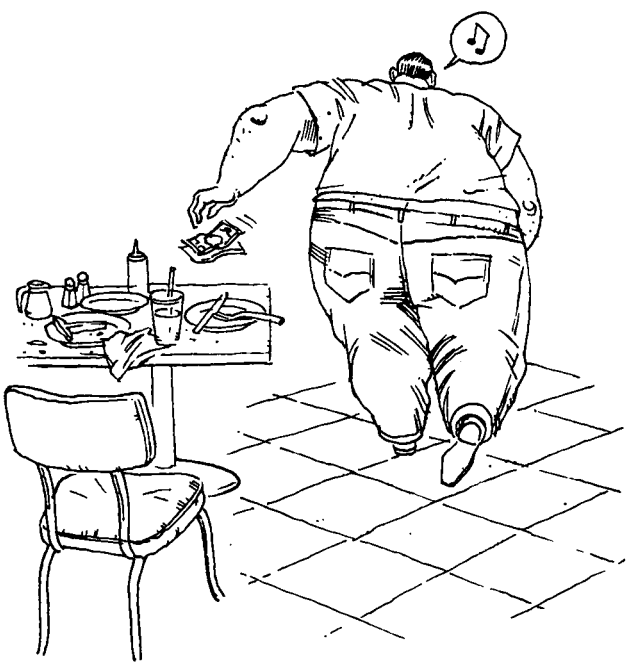
tion of the pen-toilet area is to house the ashtrays in which servers and dishwashers leave their cigarettes burning at all times, like votive candles, so they don't have to waste time lighting up again when they dash back here for a puff. Almost everyone smokes as if their pulmonary well-being depended on it. I don't know why the antismoking crusaders have never grasped the element of defiant self-nurturance that makes the habit so endearing to its victims – as if, in the American workplace, the only thing people have to call their own is the tumors they are nourishing and the spare moments they devote to feeding them.

Now, the Industrial Revolution is not an easy transition, especially, in my experience, when you have to zip through it in just a couple of days. I have gone from craft work straight into the factory, from the air-conditioned morgue of the Hearthside directly into the flames. Customers arrive in human waves, sometimes disgorged 50 at a time from their tour buses, peckish and whiny. Instead of two "girls" on the floor at once, there can be as many as six of us running around in our brilliant pink-and-orange Hawaiian shirts.

I start out with the beautiful, heroic idea of handling the two jobs at once, and for two days I almost do it: working the breakfast/lunch shift at Jerry's from 8 till 2, arriving at the Hearthside a few minutes late, at 2:10, and attempting to hold out until 10. In the few minutes I have between jobs, I pick up a spicy chicken sandwich at the Wendy's drive-through window, gobble it down in the car, and change from khaki slacks to black, from Hawaiian to rust-colored polo. There is a problem, though. When, during the 3 to 4 p.m. dead time, I finally sit down to wrap silver, my flesh seems to bond to the seat. I try to refuel with a purloined cup of clam chowder, as I've seen Gail and Joan do dozens of time, but Stu catches me and hisses, "No eating!" although there's not a customer around to be offended by the sight of food making contact with a server's lips. So I tell Gail I'm going to quit, and she hugs me and says she might just follow me to Jerry's herself.



Gail would have triumphed at Jerry's, I'm sure, but for me it's a crash course in exhaustion management. Years ago, the kindly fry cook who trained me to waitress at a Los Angeles truck stop used to say, "Never make an unnecessary trip; if you don't have to walk fast, walk slow; if you don't have to walk, stand." But at Jerry's the effort of distinguishing necessary from unnecessary and urgent from whenever would itself be too much of an energy drain. Ideally, at some point you enter what servers call a "rhythm" and psychologists term a "flow state," where signals pass from the sense organs directly to the



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muscles, bypassing the cerebral cortex, and a Zen-like emptiness sets in.

But there's another capacity of the neuromuscular system, which is pain. I start tossing back drugstore-brand ibuprofens as if they were vitamin C, four before each shift, because an old computer-mouse related repetitive-stress injury in my upper back has come back to full-spasm strength, thanks to the tray carrying. In my ordinary life, this level of disability might justify a day of ice packs and stretching.

Management at Jerry's is generally calmer and more professional than at the Hearthside, with two exceptions. One is Joy, a plump, blowsy woman in her early 30s who once kindly devoted several minutes of her time to instructing me in the correct one-handed method of tray carrying but whose moods change disconcertingly from shift to shift and even within one. The other is B.J., aka B.J. the Bitch, whose contribution is to stand by the kitchen counter and yell, "Nita, your order's up, move it!" or, "Barbara, didn't you see you've got another table out there? Come on, girl!"

Among other things, she is hated for having replaced the whipped cream squirt cans with big plastic whipped-cream-filled baggies that have to be squeezed with both hands – reportedly because she saw or thought she saw employees trying to inhale the propellant gas from the squirt cans, in the hope that it might be nitrous oxide. On my third night, she pulls me aside abruptly and brings her face so close that it looks like she's planning to butt me with her forehead. But instead of saying, "You're fired," she says, "You're doing fine." The only trouble is I'm spending time chatting with customers, "That's how they're getting you."

Chatting with customers is for the good-looking young college-educated servers in the downtown carpaccio and ceviche joints, the kids who can make $70 to $100 a night. What had I been thinking? Customers are in fact the major obstacle to the smooth transformation of information into food and food into money – they are, in short, the enemy. And the painful thing is that I'm beginning to see it that way myself. There are the traditional asshole types – frat boys who down multiple Buds and then make a fuss because the steaks are so emaciated and the fries so sparse, as well as the variously impaired – due to age, diabetes, or literacy issues – who require patient nutritional counseling.

The worst, for some reason, are the Visible Christians – like the 10-person table, all jolly and sanctified after Sunday night service, who



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run me mercilessly and then leave me $1 on a $92 bill. Or the guy with the crucifixion T-shirt ("Someone To Look Up To") who complains that his baked potato is too hard and his iced tea too icy (I cheerfully fix both) and leaves no tip at all. As a general rule, people wearing crosses or "WWJD?" ("What Would Jesus Do?") buttons look at us disapprovingly no matter what we do, as if they were confusing waitressing with Mary Magdalene's original profession.

I make friends, over time, with the other "girls" who work my shift. As at the Hearthside, the only recreation ever referred to is partying, which requires little more than some beer, a joint, and a few close friends. Still, no one is homeless, or cops to it, anyway, thanks usually to a working husband or boyfriend. All in all, we form a reliable mutual-support group; if one of us is feeling sick or overwhelmed, another one will "bev" a table or even carry trays for her. If one of us is off sneaking a cigarette or a pee, the others will do their best to conceal her absence from the enforcers of corporate rationality.

I make the decision to move closer to Key West. First, because of the drive. Second and third, also because of the drive: gas is eating up $4 to $5 a day, and although Jerry's is as high-volume as you can get, the tips average only 10 percent, and not just for a newbie like me. Between the base pay of $2.15 an hour and the obligation to share tips with the busboys and dishwashers, we're averaging only about $7.50 an hour. Then there is the $30 I had to spend on the regulation tan slacks worn by Jerry's servers – a setback it could take weeks to absorb. Of my fellow servers, everyone who lacks a working husband or boyfriend seems to have a second job: Nita does something at a computer eight hours a day; another welds. Without the 45-minute commute, I can picture myself working two jobs and still having the time to shower between them.

So I take the $500 deposit I have coming from my landlord, the $400 I have earned toward the next month's rent, plus the $200 reserved for emergencies, and use the $1,100 to pay the rent and deposit on trailer number 46 in the Overseas Trailer Park, a mile from the cluster of budget hotels that constitute Key West's version of an industrial park. Number 46 is about eight feet in width and shaped like a barbell inside, with a narrow region – because of the sink and the stove – separating the bedroom from what might optimistically be called the living area, with its two-person table and half-sized couch. The bathroom is so small my knees rub against the shower stall when I sit on the toilet, and you can't just leap out of the bed, you have to climb down to the foot of it in order to find a patch of floor space to stand on. Outside, I am within a few yards of a liquor store, a bar that advertises "free beer tomorrow," a convenience store, and a Burger King – but no supermarket or, alas, laundromat.

When my month-long plunge into poverty was almost over, I finally landed my dream job – housekeeping. I did this by walking into the personnel office of the only place where I figured I might have some credibility, the hotel attached to Jerry's, and confiding urgently that I had to have a second job if I was to pay my rent and, no, it couldn't be front-desk clerk. "All *right*" the personnel lady fairly spits, "so it's *housekeeping*," and marches me back to meet Millie, the housekeeping manager, a tiny, frenetic Hispanic woman who greets me as "babe" and hands me a pamphlet emphasizing the need for a positive attitude. The pay is $6.10 an hour and the hours are 9 in the morning till "whenever," which I am hoping can be defined as a little before 2. I don't have to ask about health insurance once



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I meet Carlotta, the middle-aged African-American woman who will be training me. Carlie, as she tells me to call her, is missing all of her top front teeth.

On that first day of housekeeping – and the last day, although I don't yet know it – in my life as a low-wage worker in Key West, Carlie is in a foul mood. We have been given 19 rooms to clean, most of them checkouts, as opposed to stayovers, requiring the whole enchilada of bed stripping, vacuuming and bathroom scrubbing. When one of the rooms that had been listed as a stayover turns out to be a checkout, she calls Millie to complain, but of course to no avail.

I do the beds while she sloshes around the bathroom. For four hours without a break I strip and remake beds, taking about four and a half minutes per queen-sized bed, which I could get down to three if there were any reason to. We try to avoid vacuuming by picking up the larger specks by hand, but often there is nothing to do but drag the monstrous vacuum cleaner – it weighs about 30 pounds – off our cart and try to wrestle it around the floor. Sometimes Carlie lets me do the bathrooms. No service ethic challenges me here to new heights of performance. I just concentrate on removing the pubic hairs from the bathtubs, or at least the dark ones that I can see.

It is the TV that keeps us going, from Jerry to Sally to *Hawaii Five-O* and then on to the soaps. If there's something especially arresting, like "Won't Take No for an Answer" on Jerry, we sit down on the edge of a bed and giggle for a moment, as if this were a pajama party instead of a terminally dead-end job. The soaps are the best, and Carlie turns the volume up full blast so she won't miss anything from the bathroom or while the vacuum is on.

The tourists' rooms that we clean and, beyond them, the far more expensively appointed interiors in the soaps, begin after a while to merge. We have entered a better world – a world of comfort where every day is a day off, waiting to be filled with sexual intrigue. We are only gate-crashers in this fantasy, however, forced to pay for our presence with backaches and perpetual thirst. The mirrors, and there are far too many of them in hotel rooms, contain the kind of person you would normally find pushing a shopping cart down a city street – bedraggled, dressed in a damp hotel polo shirt two sizes too large, and with sweat dribbling down her chin like drool.

I don't learn much about Carlie except that she hurts. She moves slowly about her work, muttering something about joint pain, and this is probably going to doom her, since the young immigrant housekeepers – Polish and Salvadoran – like to finish their rooms by 2 in the afternoon, while she drags the work out till 6. Already, management has brought in a woman to do what sounds like time-motion studies and there's talk about switching to paying by the room.

When I request permission to leave at about 3:30, another housekeeper warns me that no one has so far succeeded in combining housekeeping with serving at Jerry's: "Some kid did it once for five days, and you're no kid." With that helpful information in mind, I rush back to number 46, down four Advils (the name brand this time), shower, stooping to fit into the stall, and attempt to compose myself for the oncoming shift. So much for what Marx termed the "reproduction of labor power," meaning the things a worker has to do just so she'll be ready to labor again. I spend most of my hour-long break between jobs attempting to remove the edible portions of the slacks with a sponge and then drying them over the hood of my



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car in the sun.

I can do this two-job thing, is my theory, if I can drink enough caffeine. I am not tired at all, I assure myself, though it may be that there is simply no more "I" left to do the tiredness monitoring.

Then it comes, the perfect storm. Four of my tables fill up at once. Four tables is nothing for me now, but only so long as they are obligingly staggered. As I bev table 27, tables 25, 28 and 24 are watching enviously. As I bev 25, 24 glowers because their bevs haven't even been ordered. Twenty-eight is four yuppies, meaning everything on the side and agonizing instructions as to the chicken Caesars. Twenty-five is a middle-aged black couple who complain, with some justice, that the iced tea isn't fresh and the tabletop is sticky. But table 24 is the meteorological event of the century: ten British tourists who seem to have made the decision to absorb the American experience entirely by mouth.

Here, everyone has at least two drinks – iced tea *and* a milkshake, Michelob *and* water (with a lemon slice in the water, please) – and a huge, promiscuous orgy of breakfast specials, mozzarella sticks, chicken strips, quesadillas, burgers with cheese and without, sides of hash browns with cheddar, with onions, with gravy, seasoned fries, plain fries, banana splits. When I arrive with their first tray of food – after three prior trips just to refill bevs – Princess Di refuses to eat her chicken strips with her pancake-and-sausage special since, as she now reveals, the strips were meant to be an appetizer. Maybe the others would have accepted their meals, but Di, who is deep into her third Michelob, insists that everything else go back while they work on their starters. Meanwhile, the yuppies are waving me down for more decaf and the black couple looks ready to summon the NAACP.

Much of what happens next is lost in the fog of war. A menacing restlessness rises from the tables, all of which are full. Even the invincible Ellen is ashen from stress. I take table 24 their reheated main courses, which they immediately reject as either too cold or fossilized by the microwave. When I return to the kitchen with their trays (three trays in



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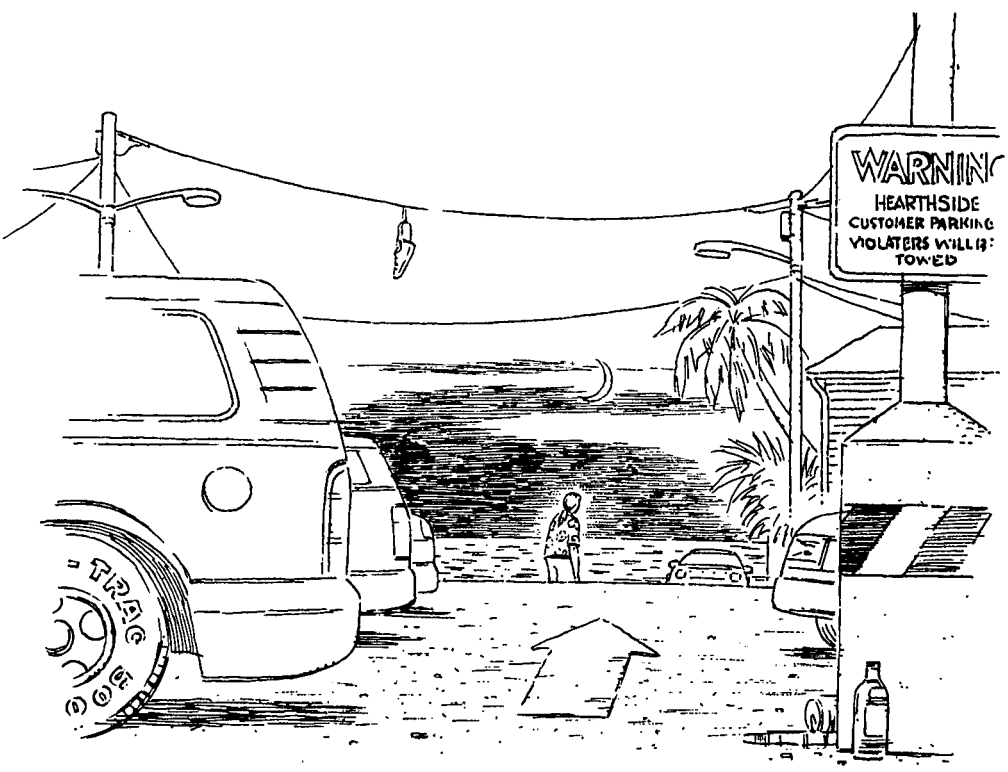
three trips) Joy confronts me with arms akimbo, "What is this?" She means the food – the plates of rejected pancakes, hash browns in assorted flavors, toasts, burgers, sausages, eggs. "Uh, scrambled with cheddar," I try, "and that's…"

"No," she screams in my face, "is it a Traditional, a Super-Scramble, an Eye-Opener?" I pretend to study my check for a clue, but entropy has been up to its tricks, not only on the plates but also in my head, and I have to admit that the original order is beyond reconstruction.

"You don't know an Eye-Opener from a Traditional?" she demands in outrage. All I know, in fact, is that my legs have lost interest in the current venture and have announced their intention to fold. I am saved by a yuppie (mercifully not one of mine) who chooses this moment to charge into the kitchen to bellow that his food is 25 minutes late. Joy screams at him to get the hell out of her kitchen, *please*, and then turns on Jesus in a fury, hurling an empty tray across the room for emphasis.

I leave. I don't walk out, I just leave. I don't finish my side work or pick up my credit card tips, if any, at the cash register or, of course, ask Joy's permission to go. And the surprising thing is that you *can* walk out without permission, that the door opens, that the thick tropical night air parts to let me pass, that my car is still parked where I left it. There is no vindication in this exit, no surge of relief, just an overwhelming dank sense of failure pressing down on me and on the entire parking lot. I had gone into this venture in the spirit of science, to test a mathematical proposition, but somewhere along the line, in the tunnel vision imposed by long shifts and relentless concentration, it became a test of myself, and clearly I have failed. M



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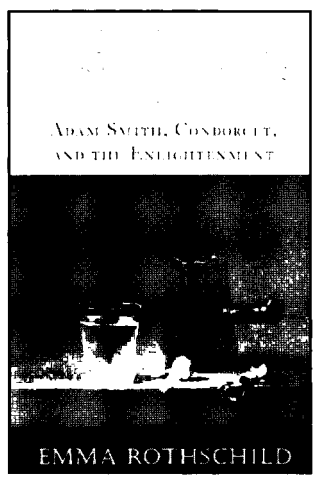
**In one of** many delicious anecdotes reported in *Economic Sentiments*, Emma Rothschild describes how the revolutionary turmoil in France triggered a backlash against the language of the Enlightenment. An English shipowner who had christened a vessel "The Liberty" was urged by "aristocratic friends" to rename it "The Freedom." The difference? "[P]eople might then think only of Freedom of Trade, whereas Liberty has a jacobinical sound with it!"




**Economic Sentiments: Adam Smith, Condorcet and the Enlightenment**

**by Emma Rothschild**

*Harvard University Press, 2001*
*353 pp. $45.00*

**Reviewed by Sylvia Nasar**

Adam Smith, the great Scottish philosopher/economist, is the hero of Ms. Rothschild's eloquent and erudite narrative, and the anecdote illustrates how – and why – much of Smith's meaning was inverted to suit the reactionary tenor of the years following his death in 1790. When alive, the author of "a very violent attack... upon the whole commercial system of Great Britain," was known as "a subversive" and "a friend of French philosophy." He was also a critic of established religion, imperialist wars, and the manipulations of laws by the rich "to oppress the poor." Yet, by the mid-1790s, he had been recast as "a theorist of established institutions."

Smith is still generally regarded as the apostle of commercial freedom, a patron saint of conservative politicians from Margaret Thatcher to Ronald Reagan. Ms. Rothschild, a historian at Kings College, Cambridge University, has set out to restore the pre-Restoration, politically incorrect Smith. By showing how Smith's ideas converged with those of French *oeconomistes* like the Marquis du Condorcet, and by recounting contemporary debates over food shortages, the apprenticeship system and public education, Ms. Rothschild makes a compelling case that Smith was more committed to liberty and justice – just as his French friends were more committed to free markets – than his reputation suggests.

Not all readers will agree with Ms. Rothschild that Smith's famous metaphor, the Invisible Hand, was little more than a mild ironic joke. But most will find her reinterpretation

**SYLVIA NASAR**, the author of *A Beautiful Mind* (Touchstone, 1999), teaches at the Columbia University School of Journalism.



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of Smith illuminating. Among her revelations: he valued liberty of all kinds as an end in itself, saw economic life not only as wealth creation, but "as a process of emancipation," and believed that society's highest obligation was to the autonomy and security of its poorest members. By emphasizing Smith's democratic disposition, Ms. Rothschild has also evoked a warmer, more innocent Enlightenment. "I have looked, like Adam Smith in the Philoctetes of Sophocles, for a romantic wildness," she writes.

### THE FREE AIR OF LIBERTY

By the early 1800s, Smith's conservative disciples were claiming that his political economy was "applicable alike to a despotism and a democracy." Ms. Rothschild shows that this is not, in fact, what Smith believed. For Smith, "One's freedom to buy or sell or lend or travel or work is difficult to distinguish from the rest of one's freedom," she writes. He objected to the laws of settlement that oppressed the poor; to laws requiring Germans to feed the sovereign's horses; to licensing regulations that cramped the style of small wine merchants; to draconian sanctions against farmers who dared to export sheep.

Of all Smith's diatribes in *The Wealth of Nations*, Rothschild points out, only one is aimed at national government. His chief targets are the bureaucratic constructs of civil society: parish councils, guilds and corporations, religious institutions, incorporated towns and privileged companies.

Unlike the aristocratic friends of the shipowner, Smith did not see freedom in utilitarian terms – as "a necessary evil in the process of money getting," Rothschild explains. "A system of natural liberty" in which individuals make choices about how to live was "more just than a system in which these choices are the objects of government regulations."

All citizens, including the poor, Smith insisted, wanted to "breathe the free air of liberty and independency."

### IT IS BUT EQUITY

Smith defined social justice, not abstractly as the greatest happiness for the greatest number, but in terms of the freedom and security of the most disadvantaged. *The Wealth of Nations* bristles with the concrete predicaments, vexations and tribulations of seamstresses, sailors and apprentices. "No society can surely be flourishing and happy of which the far great part of the members are poor and miserable," he wrote. Deeply skeptical as he was of government, he favored progressive taxation (to provide poor relief) and public education.

Ms. Rothschild is not, of course, the first historian to point out that Enlightenment economic thought was friendly to the poor. In his great *Principles of Economics*, published in 1890, Alfred Marshall said of the French economists that "the chief motive of their study was not to increase the riches of merchants and fill the exchequers of kings; it was to diminish the suffering and degradation, which was caused by extreme poverty." In the 1920s, Carl Menger, the Austrian economist, wrote "there is not a single instance in A. Smith's work in which he represents the interest of the rich and powerful as opposed to the poor and weak." Yet Smith's passion for justice is the most neglected aspect of his thought.

### THE UNFRIGHTENED MIND

Smith's concern with sentiments – opinions, expectations, self-regard, etc. – link his thinking to Condorcet's. "It is chiefly from this regard to the sentiments of mankind, that we pursue riches and avoid poverty," he wrote.

For Smith, the history of commerce is "an epic of the emancipation of the human



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mind." Smith's "epic of the emancipation" begins with "the human mind neglected, uncultivated, depressed" in the "thick and heavy" darkness of feudal Europe. The great promise of commercial and liberal society – "a certain degree of confidence in the justice of government" is that minds of individuals are less frightened. "When law has established order and security, and subsistence ceases to be precarious, the curiosity of mankind is increased, and their fears diminished."

As Ms. Rothschild puts it, "The sources of economic opulence were to be found... in the unfrightened mind." Once freed from fear, Smith wrote, "Every individual, it is evident, can, in his local situation, judge much better than any statesman or lawgiver can do for him." By contrast, he observes, "the man of system... seems to imagine that he can arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chess board. He does not consider that... in the great chess board of human society, every single piece has a principle of motion of its own."

**ENLIGHTENMENT**

Ms. Rothschild's success in drawing new lessons from the Enlightenment couldn't be timelier. As citizens of today's democracies are suddenly all too aware, Enlightenment values are again under attack. The disputes of the late 18th century have, as she says, "continued in one form or another – over laissez faire and the state, over respect and disrespect for established institutions, over reason and faith – throughout the entire period that separates Adam Smith's times and our own." A better understanding of the period when laissez faire was new – and intimately linked, in the thought of leading philosophers, with the passion for liberty and justice for all – can help us better grasp what is at stake now. M

DAVID SMITH

Yes, you knew it all along: The caricature on the spine of the last four issues of the *Milken Institute Review* is of the economist Joseph Alois Schumpeter (1883-1950). But do you know what he did?

So glad you asked. Born and trained in the dying Austro-Hungarian empire, Schumpeter made his way to Harvard in 1932, with intermediate stops as the finance minister of the Austrian republic, the president of a bank, and an academic in pre-Hitler Germany. The gist of his rambling writings on long-term business cycles, economic development, and the decline of capitalism are a bit hard to summarize. And for several decades after his death your average academic, immersed in either Keynesian short-term business cycle analysis, or in the quantification revolution sweeping through the profession, was inclined to dismiss him as a thinker whose time had passed.

But with the new focus on the technology and entrepreneurship in America's economic renaissance, he's back in fashion. Schumpeter's most relevant insight is that competition drives growth through innovation, rather than through marginal improvements in efficiency and productivity. Thus, according to Schumpeter, "creative destruction" – as in, say, Polaroid's decline in the wake of same-day conventional film processing and digital imaging – is as natural as Mom's apple strudel.

In this Schumpeterian world, it's worth noting, monopoly is less dangerous because potential rivals can make end-runs around the relevant market. Or, as both friends and foes of Microsoft are fond of pointing out, the real threat to the dominance of Windows isn't a better PC operating system, but technology that reduces the importance of operating systems in general – aka The Next Big Thing.



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BY ROSS DEVOL

**Heralded as the** bright star in America's economic future less than two years ago, the very idea that something called The New Economy even exists is now being called into question. And for a good (psychological) reason: few investors want to be reminded about what's happened to the high-flying tech stocks of the late 1990s. And even fewer of the software engineers and MBAs who staked their careers on dot-coms of the month are eager to revisit the scene of the crime.

The subject also has a way of making otherwise sober-minded experts cringe. Could we have really believed that profitability was irrelevant to corporate success? Could anyone have imagined that the Nasdaq was not overvalued in March 2000 when its market capitalization was 245 times earnings? Could serious people have seriously argued that the business cycle was obsolete, or that the sustainable rate of productivity growth had doubled virtually overnight?

But now that it is so fashionable to dance on the grave of The New Economy, perhaps it is time for a more realistic appraisal. Certainly pundits made exaggerated claims for it, but today's skeptics are plainly erring on the other side. Betting against the technology-enabled New Economy in 2001 is similar to dumping auto manufacturers' stocks in 1908 because it was a bad year for car sales. The technology sector is in a consolidation phase, but it is a cyclical slowdown – not a structural one. The business models of many dot-coms may have borne an embarrassing resemblance to those underpinning 8-year-olds' lemonade stands, but the demise of silly Internet businesses hardly refutes the fact that new technology is changing the rules in many sectors of the economy.

Start by separating New Economy fiction from the facts at the macro level.

**The business cycle revisited.** The notion that the business cycle has been repealed is not a new one. Similar optimism was expressed in the mid- and late-1920s (just before the onset of the Great Depression) and again during the long expansion of the 1960s (just prior to the 1970 downturn and the severe 1974-75 recession).

Of course, forecasts of unending economic expansion have always proven incorrect. Business-cycle peaks are nearly impossible to see in advance – and, indeed, sometimes difficult to recognize in the rearview mirror. Many New Economy proponents espoused the view that information technology would smooth out the business cycle and eliminate recessions. But as this is being written, the economy is once again flirting with recession.

**ROSS DEVOL is director, office of the chairman and regional and demographic studies at the Milken Institute.**



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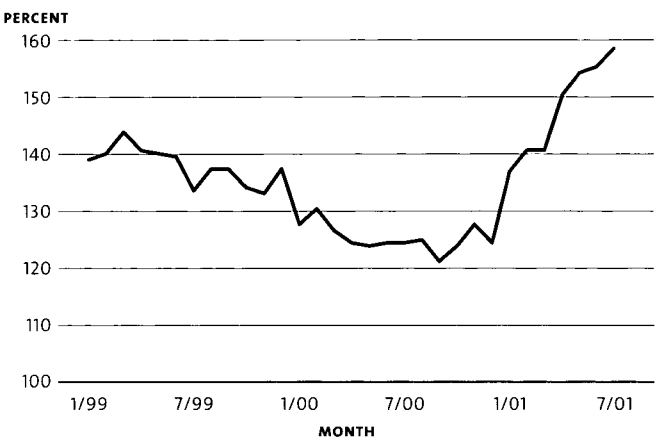
**Inventories.** A key rationale for believing that business cycles were a thing of the past was the greater capacity to manage inventories made possible by computerized databases and instant communication. Computerized management, the reasoning went, gave business the ability to prevent unwanted buildups in inventory – and thereby the need to cut production to correct mistakes.

Changes in inventory investment do, indeed, represent a large proportion of the variation in total business investment over the business cycle. But that fact does not imply inventory changes cause recessions – in many cases, they may simply be the effect.

Sophisticated management of inventories can go a long way to reducing the degree to which changes in inventory investment propagates economic shocks. But a major unanticipated shock can still lead to an inventory accumulation that must be liquidated. The recent dramatic slowing in the economy has led to a buildup in inventories, especially in IT equipment, and manufacturers are slashing production schedules accordingly.

**IT INVENTORIES ARE PILING UP**

**INVENTORY AS A PERCENTAGE OF SALES FOR COMPUTER/ELECTRONIC PRODUCTS**




**Investment.** Another misplaced notion was that IT equipment investment is recession-proof. According to the theory, purchases of IT equipment would be unaffected by downturns because businesses subject to rapid technological change couldn't afford to lose their edge. Firms, in both old and new industries, would be compelled to invest continually in the best stuff in order to remain competitive.

But at least some lemmings pause at the edge of the cliff: businesses can and do still trim investment when earnings and forecast demand fall. Firms decided that they didn't need the latest Pentium 4 computers, network servers and e-mail systems. In the first quarter of 2001, investment in IT hardware and software declined at an annual rate of 12 percent. The rate of decline accelerated to 19 percent in the second quarter. This is in contrast to 20 percent average annual growth from 1995 to 2000.

**Productivity.** Wasn't The New Economy supposed to boost productivity growth forever? Skeptics point to the 1.2 percentage point drop in productivity growth in the first quarter of 2001 as proof that higher sustainable productivity was a mirage. But their somewhat perverse jubilation was cut short by the 2 percentage point-plus productivity rebound in the second quarter. Forecasts of sustainable productivity growth in excess of 3 percent were plainly too optimistic, but there is every reason to believe that investment in informa-



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tion technology will pay off over the long term.

What about the fall in productivity witnessed in the first quarter? This is a red herring; in the early stages of an economic slowdown, productivity always dips because firms are reluctant to cut jobs at first as output contracts. But as it becomes clear that growth has stalled, employers wield their axes. This process commenced in the second quarter. And all told, productivity has held up remarkably well in the current downturn.

The pundits who placed their bets on long-term productivity growth of 3 percent or more will, no doubt, be proven wrong, since much of the post-1995 acceleration in productivity was cyclical. The IT boom will not be repeated. The industries producing IT equipment recorded productivity growth substantially above other sectors, and because they represented such a high share of total output growth, overall productivity growth was temporarily elevated. Look for sustainable productivity gains in the 2 percent range when the current downturn ends.

You really need to drill down to the microeconomic level, though, to understand how information and communication technologies are changing the economy in fundamental ways. Information exchange is at the core of an efficient economy. The most direct impact of new information technology has been to flatten the corporate hierarchy, eliminating the need for layers of middle management and decentralizing decision-making. Paradoxically, IT is causing some industries (financial services, telecommunications, energy and autos) to consolidate to take advantage of economies of scale, while allowing small firms to improve their ability to innovate and compete with large ones.

The New Economy is thus much more than the accumulation of new technologies. It is changing how we use technology as a tool in every facet of our work and personal lives. Harvard professor Michael Porter perhaps summarized it best: "Today there is no such thing as a low-tech industry. There are only low-tech companies." You either incorporate technology wisely into your business practices or become noncompetitive – and likely exit.

The core value of information technology is in the networks that it facilitates. Metcalfe's Law postulates that as the number of nodes on a network increases arithmetically, the value of a network increases exponentially. Thus the value of adding an incremental user is greater for the network than it is for the new user. This positive externality, making the value of the whole greater than the sum of the parts, is the essential enabler of The New Economy.

At the center of all this is the Internet. Created in the late 1960s as a backup network for the defense establishment, the Internet evolved into an open global network in the 1990s. In only a few years as a public entity, it has changed the way we interact. As Brad Delong, an economist at the University of California at Berkeley, put it, "IT and the Internet amplify brain power in the same way that the technologies of the industrial revolution amplified muscle power."

**The Internet and the Telegraph.** Despite the generations that separate them, there are similarities linking the Internet to the earliest form of electronic communication: the telegraph. Each technology embraced an understanding of the emerging science of its time – electricity for the telegraph, digital computing and electronic signal processing for the Internet – to revolutionize communication. Each was developed in an effort to save time and expense associated with long-distance



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communication.

The telegraph was a breakthrough of immense proportions, but the impact of the Internet is likely to be much greater. As new methods alter communication, our institutions evolve to reflect the new reality. This includes economic markets, which achieve efficiencies from the availability of information in a more timely fashion and at much lower cost. The savings, among other things, expand the geographic size of markets. Such processes occurred over a century ago with the introduction of the telegraph, and are happening again with the Internet.

The real power of the Internet, however, comes from its ability to organize and manage the buying and selling of the most mundane and unglamorous business products and services. Markets for everything from chemicals to office equipment to database management services are expanding to include the entire world. Business-to-business e-commerce accounts for 70-80 percent of all income earned in cyberspace.

The Internet has accelerated communication within and between firms. Like the telegraph, the Internet connects companies to one another and to their suppliers, allowing organizations to link their computer systems. With this level of integration, coordination costs associated with organizing individuals, materials, production, inventories and transportation are reduced, as orders can now move directly from supplier to customer.

Like the telegraph before it, the Internet unleashes market forces driving efficiency gains in large-scale operations. The Internet allows flatter organization hierarchies, while at the same time facilitating market specialization and market access for smaller firms.

The Internet may represent less of an intellectual leap than the telegraph or the printing press, but it could have a greater economic impact. It has reduced the cost of communications more rapidly and has been disseminated through the economy more rapidly.

Don't give up on The New Economy or the Internet because of the dot-com flameouts. Future productivity gains from the Internet and linking of computers will justify share prices above today's valuations. An increase in sustainable productivity growth of 0.5-1.0 percentage points per year may not seem like much, but decades of such growth would change everything. And that is the true measure of what The New Economy means. M

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**ANSWERS TO THE PUZZLER, PAGE 72**

"...I had no idea where the property boundaries were but the dogs knew. Every time I crossed from one farm to another, a different dog barked. Those Indonesian dogs...had the basic information needed to set up a formal property system." — DeSoto, *The Mystery of Capital.*

A. deep fried
B. ever
C. SHAEF
D. opt out
E. teetered
F. oriented
G. Toy Story
H. haddock
I. emphases
J. mood ring
K. Yemen
L. swing shift
M. twitters
N. end of gender
O. re-enters
P. Yoruba
Q. order about
R. feeder
S. chainsaw
T. abdomen
U. photon
V. in a bind
W. tamarisk
X. aphorism
Y. loofah



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I SAW THE NIGHTMARE SMOKE OUT MY WINDOW, LOOKING DOWNTOWN.
I SAW TEN LARGE REFRIGERATOR TRUCKS FOR CORPSES AND BODY PARTS ESCORTED BY POLICE CARS PAST THE FRONT OF MY BUILDING.
I SAW THE PRESIDENT'S BOLD WORDS.
I SAW QUAVERING ON TV IN RUMSFELD AND BOB WOODWARD AND MANY OTHERS.
FOREIGN POLICY IS A GORDIAN KNOT TO ME.
I HOPE WE ELECTED THE RIGHT PEOPLE. I HOPE THEY MAKE WISE CHOICES.
I'M NOT A FANATICAL GUERRILLA WARRIOR.
I'M NOT JOHN WAYNE.
SHOULD I WORK IN A FACTORY OR FEED PEOPLE ON A SOUP LINE OR WHAT? TELL ME WHAT I CAN DO, I'LL DO IT.
I'VE LEARNED THAT FIREMEN ARE SAINTS. AND SO ARE SOME POLICEMEN
I'VE EXPERIENCED RUDY GIULIANI AS THE FATHER MY OWN FATHER AND I ALWAYS LONGED FOR.
MY WIFE IS A BUDDHIST. SOMETIMES I PARTICIPATE. HER TEACHER QUOTES A BUDDHIST PRAYER:
"UNBEARABLE COMPASSION RADIATES UNCEASING LOVE."
UNBEARABLE HORROR HAS FLOODED US WITH COMPASSION AND LOVE. THAT'S WHERE I LOOK FOR SOLACE AND WHAT TO DO.

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